WHY DEVELOPERS GO PUBLIC: THE USE OF REAL ESTATE INVESTMENT TRUSTS IN THE DEVELOPMENT PROCESS

by

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ABSTRACT

At its original inception in 1960, the Real Estate Investment Trust (REIT) was created as a vehicle for passively holding and overseeing properties for the benefit of its shareholders. In that context, real estate development seems like an unlikely pursuit for a REIT. Nevertheless, a small number of REITs have adopted value-creation strategies to build their portfolios, either through development or substantial renovation of existing properties. Out of 117 tax-qualified REITs listed on the major stock exchanges, at least 13 were identified as following some type of value-creation strategy. Some have been remarkably successful, while others face losses that threaten continued operation. REITs, as investment vehicles, are generally not well understood. Little, if any, research on value-creation REITs, as a category, has been published. REITs also represent an alternative source of capital for development, an important concern in current U.S. markets where many traditional sources of both debt and equity have retreated from real estate investment.

One of two basic value-creation strategies is typically followed. First, some REITs acquire existing properties, then initiate renovation, redevelopment, expansion of existing structures and, in some cases, development of new buildings on vacant land. Second, other REITs have engaged in development s through the use of joint venture partnerships with developers. Chapter One profiles the legislative changes that have enabled REITs to pursue these more flexible investment strategies. Chapter Two presents the advantages and disadvantages of the REIT format for development and discuses the two basic approaches. Tracking the performance of six case-study REITs in Chapter Three indicates that the Acquisition & Redevelopment REITs have outperformed the younger Joint Venture group. It explores differences in the two approaches and other factors that lead to the variance in performance, both as developers and as market securities. The Conclusions section summarizes the findings and presents new alternative uses of the REIT in the development process.

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VALUE CREATION AND THE REIT-- A RECENT UNION

At its original inception in 1960, the Real Estate Investment Trust (REIT) was created as a vehicle for passively holding and overseeing properties for the benefit of its shareholders. Enabling legislation was designed to restrict REITs to that limited agenda. In that context, real estate development seems like an unlikely pursuit for a REIT. Nevertheless, a small number of REITs have adopted value-creation strategies to build their portfolios, either through development or substantial renovation of existing properties. Out of 117 tax-qualified REITs listed on the major stock exchanges, at least 13 were identified as following some type of value-creation strategy. Some have been remarkably successful, while others face losses that threaten continued operation. REITs today are being used to deploy an increasingly diverse range of investment strategies; yet as investment vehicles, they are generally not well understood. They attract a much smaller following in the investment community than other securities. Little, if any, research on value-creation REITs, as a category, has been published.

With broader usage and more specialization, the REIT has proven to be a flexible vehicle which has outgrown the three simple categories widely recognized in the industry. Based on the type of real estate assets, the National Association of Real Estate Investment Trusts (NAREIT) categorizes its member REITs into three groups: Equity REITs, which invest primarily in real properties; Mortgage REITs, which invest primarily in mortgage notes secured by real estate; and Hybrid REITs, which hold some combination of debt and equity investments. Some have suggested these three simple categories are no longer adequate to describe the broad diversity of investment strategies employed among REITs.[1] More and more REITs are adopting highly specialized investment strategies rather than diversified holdings. Specialization can be by property type, geographic region, or investment activity. A small, but notable area of specialization is through value creation-- REITs that add value to their portfolios by participating in the development or renovation of property.

Each value-creation REIT is unique, but one of two basic strategies is typically followed. First, some REITs acquire existing properties, then initiate renovation, redevelopment, expansion of existing structures and, in some cases, development of new buildings on vacant land. Historically, REITs have been able to profit from these activities (within the confines of the Internal Revenue Code) by using an advisor or an independent management firm for day-to-day property management and construction activities. The second way that REITs have engaged in development is through the use of joint venture partnerships. When REITs enter into such partnerships with independent developers, they can participate in the value creation process by providing development capital for new construction in exchange for an equity stake in the final product. This type of vested interest generally motivates REIT management to take an active part overseeing the design development, construction and leasing efforts of the properties.

Those companies that develop or renovate property under the REIT format have chosen a traditionally passive structure to pursue a very non-passive investment strategy, thus they are interesting cases to study. The REIT offers a developer wide access to capital in large portions, most notably through public equity offerings; from that standpoint it has financial appeal. But the REIT vehicle also encumbers management with a complex set of restrictions, set forth by the Internal Revenue Code, corporate laws at the state level and the Securities and Exchange Commission. This thesis seeks to identify those equity and hybrid REITs that create value through real estate development or renovation, to discuss their rationale behind choosing REIT status, and to evaluate the successes and limitations of using the REIT format to facilitate development. Findings indicate that, in some cases, the REIT vehicle effectively supports lucrative value-creation strategies, providing long-term access to capital, a favorable cost of capital, and adequate operational latitude to achieve development goals.

From Passive Investor to Active Manager: A Brief Legislative History of the REIT

The real estate investment trust was created by Congress in 1960 to permit small investors the opportunity to invest in professionally managed real estate through publicly traded securities. REITs are considered by many to be the mutual funds of the real estate industry. Unlike other corporate entities, REITs pay no federal income tax on income or gains passed through to shareholders, provided that they meet specific organizational and operational requirements. From an investor's perspective the REIT permits investment in real estate without the obstacles of large capital outlays and illiquidity normally associated with individual property ownership. From management's perspective the REIT can be a flexible vehicle that permits a wide array of strategies to invest in virtually any form of real estate including fee interests, mortgages secured by real estate, leaseholds, options, and shares in other REITs or securitized real estate. The REIT vehicle can also serve as a tool to raise public and private capital, both debt and equity, to fund investments.

The Ground Rules for REIT Status

The basic organizational requirements have changed only slightly since 1960. The current requirements are: 1) A REIT must distribute at least 95% of net taxable earnings to shareholders; 2) A REIT must be managed by one or more directors or trustees; 3) During the last half of each taxable year, no more than 50% of the shares can be owned by five or fewer individuals; 4) A REIT must report on a calender year basis; 5) Subject to changes in the 1986 Tax Reform Act, a REIT must engage independent real estate professionals (i.e. independent contractors) to carry out certain management activities; 6) A REIT must have at least 100 shareholders.

Creating a Special Mutual Fund

The original proponents who lobbied for the creation of the REIT vehicle in the late 1950s were property management companies wanting to securitize and sell equity interests in existing-owned properties, with the same tax advantages as their contemporaries in the mutual fund industry. In drafting the legislation, Congress made certain that only the real estate income or "rents from real property," not profit from property management services, would be exempt from taxation. The concern was that if a real estate intensive business, like a hotel for example, elected to seek REIT status, the proceeds from the hotel operations could go untaxed.[2] To prohibit such loopholes the law stipulated that a REIT must be a passive investment entity and not an operating company.

The resulting income requirements of a REIT, as they stand today, are: 1) "The 75% Income Requirement" which means that 75% of the gross annual income of a REIT must be derived from rents from real property, mortgage interest, gains from sale or other distributions of real property, dividends or other distributions on and gain from the sale of shares in other REITs, income and gain from foreclosure property, or mortgage loan fees. 2) "The 95% Income Requirement" holds that at least 95% of the annual gross income must be derived from the items set forth above, plus other interest, dividends and gains from the sale of stock and securities. 3) "The 30% Income Limitation" requires that less than 30% of annual gross income must be derived from the gains from sale of certain property held less than four years and short term gains from sale of securities and other miscellaneous items.

Congress' concern for isolating management income resulted in casting off the management role from the REIT itself. The law required that a REIT arrange for the management of its portfolio holdings by independent contractors. REITs were also severely restricted from holding properties for sale after they had been acquired. This was to insure that gains from speculative sales, particularly by home building companies, would not escape taxation. (Even today, after several rounds of legislative reforms, home builders cannot qualify as a REIT.) Congress intentionally, perhaps naively, modeled the REIT after the mutual fund. This was naive because, unlike a portfolio of stocks, real estate is a physical asset that requires intensive property management. The restrictions on management activities have served as a source of frustration and, in some cases, litigation for REIT managers ever since.

Only in recent years have REITs been allowed to self-manage properties and operations. Yet, certain tenant services, such as interior finish construction and fee automobile parking, among others, are still forbidden by REIT regulation.

What a REIT can and cannot do within the letter of the law is suggested rather than spelled out exactly. Even attorneys specializing in REIT counsel consider sections 856-860 of the Internal Revenue Code ("The Code") to be vague on certain points. The strictest interpretation of the current Code would indicate that REITs, as passive investment vehicles, are prohibited from directly managing, operating, much less developing real properties.[3] In practice however a number of REITs are now self-managed, which means they can lease and operate their own buildings.

Problems Push Reforms in the 1970s

Over time, through subsequent reforms and small incremental interpretaions of the Code, the REIT has evolved from a legislative skeleton to a flexible operating entity. As flexibility increased, REIT managers have also discovered more creative ways to exploit new opportunities, still within the confines of the rules. The first major break came in 1975 when REITs were granted the right to sell foreclosure properties. Prior to this reform, REITs forced into a prohibited transaction risked the "sudden death" penalty, immediate disqualification as a REIT and full corporate taxation. This and a few other positive reforms grew out of a negative set of circumstances-- The industry's major debacle in the early 1970s. During that period many REITs were forced to foreclose on mortgage and construction loans. As a result, these REITs suddenly had properties that they never intended to own; they became equity REITs by default. The Internal Revenue Code, basically unchanged since 1960, was so restrictive that the REITs could neither sell nor effectively manage the properties, without entirely giving up the shelter of REIT status. By necessity, reforms recast opportunity in the troubled industry.

A REIT boom period preceded the 1974 bust and its reforms. Some of the earliest REITs of the 1960s were organized to invest in first mortgage residential loans, most of which were insured by the Federal Housing Administration or guaranteed by the Veterans Administration. REIT managers soon realized that they could enlarge the asset base and increase the return to shareholders, from these relatively secure loan portfolios, through the use of long-term debt borrowed at a cost less than the rate of return generated by the mortgage loan holdings. Such use of leverage allowed REITs to provide geometrically increasing dividends from quarter to quarter.

As REITs became established as attractive investment vehicles, the securities market came to expect such exponential growth. Eventually, the early conservative portfolios evolved to include construction and development loans, shorter term mortgages and wrap-around loans. Attractive short-term borrowing rates led to the financing of these shorter term portfolio investments through revolving bank credit, commercial paper and other short-term debt instruments. Gradually, some REIT managers moved into equity-oriented investments such as outright ownership of property, land leaseholds, and joint ventures with real estate developers, with options to purchase equity or share in the anticipated appreciation in value of the underlying property. Many of these basic techniques, born in the heyday of the boom, are still employed today by development REITs.

By the early 1970s, in pursuit of the increasingly higher dividend returns that the securities market now routinely demanded, REIT managers felt compelled to make investments with increasingly attractive rates and, in many cases, increased risks.[4] In 1973 total gross book assets of REITs grew to exceed $20 billion. During that single year the industry debt-to-equity ratio rose from 1.7:1 to about 2.5:1. With such heavy allocations of mostly short-term debt, REITs were extremely vulnerable to changing economic conditions, particularly those REITs with large interest-sensitive portfolios of construction and development loans. When short-term interest rates suddenly and rapidly increased, REIT portfolios became unprofitable and their borrowers began to default on mortgages. The party was over. The middle 1970s saw drastic portfolio reorganizations and radical measures to reduce short-term debt and trim unprofitable portfolios. From 1974 to 1975 aggregate REIT assets tumbled from $20 billion to $12 billion and continued declining each year through 1980.[5]

In the eyes of some investors, the drastic shake out of the 1970s still tarnishes the reputation of the REIT industry. Some REIT managers, equity REITs in particular, performed well through the debacle and have since recovered to strong financial positions. This industry crisis also shook Congress into drafting a more flexible statutory framework. Among other changes, the qualifying income requirements were relaxed, safe harbor provisions allowed holding property for sale, difficulties of dealing with foreclosed property were eased, and late payment of dividends was no longer penalized by complete disqualification.[6] Prior to the reforms defining qualified income, a REIT could not so much as sell breath mints in the building lobby without risking complete disqualification. These changes helped REITs to attract and retain tenants by becoming more effective property managers. In 1976, another legal break was granted when Congress lifted the requirement that a REIT be organized as a business trust. Now corporations could qualify for the full tax advantages of REIT status. Incorporating gave REITs greater operational flexibility, allowing relief from certain state-level laws that limited the activities of a business trust.

The Tax Reform Act of 1986

The next major legislation to impact REITs was the historic Tax Reform Act of 1986 (TRA 86). Most participants in the real estate industry were hit hard by the loss of numerous tax deductions that year, however, the competitive position of the REIT industry was actually enhanced in basically two ways. First, TRA 86 included several provisions sought by NAREIT that would grant REITs additional operational and organizational flexibility and that would ease start-up problems for REITs. These provisions included among others, a broadening of services a REIT could provide to its tenants, and an increase from five to seven in the number of sales per year a REIT is permitted without being exposed to the 100% tax on prohibited transactions. Also, REITs were authorized to conduct certain operations through wholly owned subsidiaries[7], thus enjoying liability protection and segmentation within the portfolio. (In other words, legal actions taken against a project protected within a subsidiary would not jeopardize the rest of the portfolio properties.) Finally, the TRA 86 enabled REITs to temporarily invest proceeds from securities offerings in non-real estate investments while negotiating long term investments or development projects.

The second and indirect way that TRA 86 strengthened REITs was by basically eliminating a good portion of their competition-- the real estate syndicators, master limited partnerships and other publicly traded partnerships. These competing securitized investment vehicles relied on depreciation write-offs, investment tax credits, and the flow through of tax losses to enhance the financial returns to investors. In contrast, REITs were never permitted to pass through tax losses, only taxable income. So, when legislation wiped out the benefits of such tax losses, the competition all but vanished, and REITs were left standing relatively favored under the new federal tax policy.

By the mid 1980s certain REITs created their own in-house, independent management firms. In practice, the only thing that made these internal management companies independent was a separate payroll to satisfy the letter of the law. The duties that these subsidiaries performed included leasing, property management, and construction supervision. Such tasks were not unlike those handled by private real estate development firms. In the last two years several REITs have been granted Private Letter Rulings from the IRS that permit such wholly owned "independent" management firms to be liquidated and absorbed by the trust. As legislators and investors have grown more familiar with real estate investments, REITs have been granted more and more autonomy. The rulings suggest that the IRS now consents that certain aspects of property management are an integral function of real estate ownership; renovation and redevelopment of portfolio properties, for example. Fee-driven development or development for immediate sale is not, and never has been, permissible. Through joint venture partnerships, however, REITs can reap the value added through development, provided that the REIT holds the property in its own portfolio for the four year minimum required by the Code. In these ways, REITs offer incredible flexibility in the types of assets and business strategies they can pursue, despite the technical tax restrictions on operations.

The REIT as a Source of Capital

Even in light of favorable changes in the tax code and more flexible private rulings, development is a more complex process using the REIT vehicle instead of a private company. REITs are laden with additional regulations and an added layer of management concerns. Aside from the tax advantages, the primary incentive for a developer to choose this path is for access to equity capital through securitization.

The development process generally requires outside sources of capital. Prior to 1986 developers could rely primarily on debt capital, which was then plentiful, to fund projects. When TRA '86 removed the incentive to maximize leverage, equity became a more important component to deal structures. Some portion of equity, or gap capital, is required by developers and entrepreneurs. A REIT is a potential source for such equity capital.

In the late 1980s access to traditional debt sources also became restricted. Due to current soft, overbuilt conditions in real estate markets, high vacancy rates , and overleveraged real estate deals of the recent past lenders (and watchful federal regulators) are particularly cautious of further real estate investment. The well publicized problems in the industry have created a generally unfavorable attitude toward real estate. REITs, however, can place debt capital without appeasing federal bank regulators. Additionally, through the use of participating mortgages and convertible debt instruments, the line between debt and equity has become blurred since the mid 1980s.[8] Today's equity instruments organized under joint venture agreements can be tailored specifically to meet the needs of the investor and to cover the front-end cash drains of the development activity. And the REIT vehicle is flexible enough to provide capital for development under almost any conceivable deal structure.

Development REITs can be borrowers too. Wiser from the 1974 debacle, many REITs use measured degrees of leverage to strengthen their capital structures through conventional bank debt and long-term mortgages. REITs can also employ the techniques of corporate finance to issue debt instruments such as convertible debentures and warrants. These sources can be sometimes be obtained at very attractive rates. The REIT is a potential source of debt, equity and "hybrid" capital.

But commitment to the REIT format should not be entered lightly. Once established, a public company must answer to shareholders each and every quarter. A company that plans to sell stock periodically to raise capital must strive to keep the value of the stock high. Faltering distributions and declining stock values can tarnish a REIT's market reputation and impair a firm's ability to raise capital for years. Is the real estate development business, with its high risks and long lead time, well suited to public ownership? Have REITs been employed to successfully develop real estate? Or is the REIT vehicle too cumbersome to allow for timely, decisive entrepreneurial action? Can operation as a REIT be an effective long-term strategy for value creation? What are the trade-offs a firm must endure to have access to public funds? Do REITs enjoy a lower cost of capital than other private firms?

There are only a few REITs in the market to serve as case studies whose activities and experiences can provide answers. Chapter Two discusses the advantages and trade offs of pursuing value-creation investment strategies as a REIT. It identifies actual development REITs and describes their various real estate activities. The two major strategies for value creation, "Acquisition & Redevelopment" versus "Joint Venture Development Partnership," are discussed in more detail. Of thirteen value creation REITs identified in the course of research for this paper, six were selected for closer study: Copley Properties, Federal Realty Investment Trust, ICM Property Investors, IRT Property Company, MSA Realty and New Plan Realty. The remainder are noted as points of comparison and contrast. Discussion in the following chapters will demonstrate that NAREIT's categories mask broad differences in investment strategies.

Chapter Three focuses on the performance of the six case-study REITs and presents empirical evidence to demonstrate that the younger Joint Venture REITs have faced internal and external difficulties which have marred performance, while the Acquisition & Redevelopment REITs have performed more favorably. Performance is evaluated in several ways-- ability to raise capital, to develop property, to manage property and produce cash flow, as well as financial risks and returns as securities. The fourth and final chapter presents the conclusions of the study and an outlook toward future uses of REITs in the development process.

TABLE 1.1

THE VALUE-CREATION REITS: NAREIT Categories

EQUITY REITS	HYBRID REITS
Chicago Dock & Canal Trust	**Copley Properties, Inc.**
Federal Realty Trust	**ICM Property Investors**
IRT Property Company	MIP Properties
MSA Realty Trust	Western Investment Trust
New Plan Realty Trust	
PCA/Sammis Industrial Fund	
PCA/Tishman Speyer, Inc.	
United Dominion Realty Trust	
Weingarten Realty Investors	

Source: *REIT Facts*, NAREIT, 1988

TABLE 1.2

THE VALUE-CREATION REITS:
Reclassified by Investment Strategy

ACQUISITION & REDEVELOPMENT REITS:	JOINT VENTURE DEVELOPMENT PARTNERSHIP REITS:
Federal Realty Trust	**Copley Properties, Inc.**
IRT Property Company	**ICM Property Investors**
New Plan Realty Trust	Mortgage Investments Plus
United Dominion Realty Trust	**MSA Realty Trust**
Weingarten Realty Investors	
Western Investment Trust	

PRIVATE REITS:
PCA/Sammis Industrial Fund
PCA/Tishman Speyer, Inc.

Bold type: Indicates the six case study REITs examined in Chapter Three.

CHAPTER TWO

UNDERSTANDING DEVELOPMENT EQUITY REITs

> *"The greatest advantage to being a REIT is our access to capital; everything else is a disadvantage. . . Is a REIT the right way to run our business? We ask ourselves that question every day."*
>
> Robert Wennett, Vice President-Acquisitions, Federal Realty Investment Trust (June 4, 1989)

Given the volume and complexity of restrictions that apply to a REIT, one has to wonder why an entreprenurial company would choose such a regulated business structure. There are some distinct advantages, but they come with disclaimers, exceptions, trade-offs, and other strings attached to public corporate ownership. The following section highlights some of the pros and cons of value creation as a REIT. Wherever possible, actual experiences of the case-study REITs are cited to provide examples. It lends context to the subsequent section of the chapter which presents the two primary value creation strategies currently in use.

Advantages of the REIT Format

<u>Pass-through Taxation</u>

Tax exemption is the fundamental advantage of the REIT format. Technically the REIT, as defined by the Internal Revenue Code, is a taxable entity. However, no corporate taxes have to be paid when 95% of net taxable income is distributed and the other income tests are fulfilled.

Investment in a REIT offers tax advantages particularly beneficial to tax-exempt and nonprofit institutional shareholders, such as pension plans. Certain nonprofits are prohibited from investing directly in debt financed property. The REIT provides an opportunity for these groups to invest in leveraged real estate without penalty.

<u>Access to Capital</u>

This is perhaps the most obvious overriding incentive for a development or investment entity to seek REIT status. The ability for a developer or development partner to sell common stock to literally thousands of individual investors in a single public offering serves as an attractive prospect, offsetting the array of operational headaches. Furthermore, this competitive advantage of access to common equity does not preclude a REIT from access to traditional sources of funds. Long term debt, short term lines of credit, joint-venture partnerships with institutional sources and other forms of private placement are all used by REITs. Primary choices for capital include:

<u>Equity Sources:</u>

> <u>Common Stock</u>: Common equity, compared to alternative debt sources, is the most expensive source of capital available to a REIT. Underwriting and printing costs are high and new shares typically trade at a discount from the appraised value of the underlying real estate. Relative to other, private sources of equity, however, certain REITs enjoy a comparatively low cost of capital through the issuance of stock.

Joint Venture Partnerships: REITs that are not large enough to invest in any one particular project can enter joint venture partnerships with institutions to effectively pool their equity. Certain institutional investors perceive REIT stock ownership to be more of a stock market investment than true real estate ownership. Such institutions would prefer the joint venture partnership over common stock ownership. (A REIT's motivation for this type of joint venture is to place capital and should not be confused developer joint venture partnerships, where the developer typically brings expertise and *seeks* capital.)

Debt Sources

Convertible Debentures: In effect, the REIT borrows money from the investor at an attractive interest rate, pays coupon rate interest until a specified future conversion date, and then pays the principal back with a predetermined number of common stock shares. These are categorized as debt capital until after conversion to equity. Most REIT managers surveyed prefer the use of this versatile instrument. They can be public or private placements, trade in foreign currencies on foreign exchanges, and in some cases can be issued without costly SEC filings and approvals.

Debt: REITs have access to virtually all forms of traditional debt capital, from short-term bank lines of credit to fixed-rate mortgage loans from institutional sources. Access to debt in general is important to cover unexpected drops in cash flow. Since distributions are mandatory, REITs cannot retain their earnings. Short-term borrowings are frequently used to bridge negative cash flows. Long term debt can be used to free up capital in completed projects in order to fund new developments. Too much debt on the balance sheet, however, will be perceived as a risk in the market and could reduce the price of the stock.

Leases: Real estate leases can give a REIT the same end result as debt, the use of land or improvements at the cost of incremental long-term payments.

Cost of Capital

Virtually all public REITs are established with the desire of gaining access to low cost equity capital. In practice, however, only certain REITs ever actually enjoy this competitive advantage. In simplified terms, the cost of common equity is equal to the dividends that a corporation must pay for all equity shares outstanding. At any point in time then, a simple measure of cost would be the current dividend payment divided by the current market price of the stock. Financial analysts call this ratio the current yield. It is not a true measure of the total cost of equity since it ignores the fixed underwriting, printing and marketing costs of a public offering, but it serves as a basis for compariing stocks.Even though all three companies in Exhibit 2.1 pay annual dividends of $1.00,

EXHIBIT 2.1

THE CONCEPT OF CURRENT YIELD

	Dividend	Price	Current Yield
Stock A:	$1.00	$8.33	12.0%
Stock B:	1.00	10.00	10.0%
Stock C:	1.00	12.50	8.0%

Company C has a lower cost of equity capital since each dividend dollar buys the use of $12.50, whereas Company A only gets $8.33. To make a profit, Company A must reinvest their equity capital in something that will bring a return higher than the 12% current yield. Company C needs only an 8% hurdle rate to profitably reinvest. Clearly, given equal distributions, the stock with the higher share price has a lower potential cost of equity capital.

As Exhibit 2.2 illustrates, the A&R group enjoys a lower current yield than the Joint Venture group. In the case of an equity real estate company, market price per share reflects arguably two things: first, the underlying value of the real estate and second, the performance of the income component of the return, dividends, over time. Dividends are a product of cash flow which, for a REIT, is derived from net operating, or rental, income. Intuitively then, a REITthat offers competitive dividends and owns a sizeable portfolio of income-producing property should boast a higher market price per share, and a lower currentyield. This raises an important distinction between our two groups of development REITs. Those in the Joint Venture group started business with little or no income

EXHIBIT 2.2

COMPARISON OF ACTUAL CURRENT YIELDS

REIT	Annual Dividend	Price	Current Yield
Joint Venture REITs			
Copley Properties	$1.44	$12.00	12.0%
ICM Property Inv.	0.48	7.63	6.3%*
MIP Properties	0.40	3.75	10.7%
MSA Realty	0.60	6.00	10.0%
Acquis. & Redevelopment REITs			
Federal Realty	$1.40	$20.25	6.9%
IRT Property Co.	1.16	11.25	10.3%
New Plan	1.08	17.25	6.3%
United Dominion	1.24	16.13	7.7%

Source: *Wall Street Journal*
Notes: Prices on June 29,1990. Dividends reflect total distributions, previous twelve months.
* ICM lowered its quarterly dividend from .34 to .12 in second quarter of 1989. Current yield at the old rate ,annualized, would be 17.82%.

producing properties; cash flow was anticipated and subsidized during the interim development period, through the use of debt, by the joint venture. In contrast, over the same period of time, mid 1980s to the present, the A&R REITs subsidized their development efforts with the rental income of accumulated portfolios of property.

The Acquisition & Redevelopment REITs have been able to raise equity capital at very attractive rates. On occasion, New Plan Realty for example, was able to profit by temporarily reinvesting the money into government securities, a virtually risk-free investment. Since the initial offerings of Copley, ICM, and MSA, however, none have been able to make any subsequent equity offerings because falling stock prices have pushed up current yields to levels that would not justify reinvestment in real estate development. A low cost source of equity capital is a desired advantage of the REIT format, but not a certainty.

Flexibility

Most REITs can operate in any state or city where management perceives an opportunity. REITs can acquire or develop any desired property types and enter partnership agreements with virtually any developer, institution, or other entity, as long as those agreements are carefully structured so that the proceeds from partnerships do not violate the income tests of the Code. Copley Properties, Inc. and ICM Property Investors, for example, have diversified by investing in office and industrial properties in several metropolitan areas across the country with many different development partners. MSA Realty, on the other hand, has a very specialized and concentrated investment plan of investing only in retail projects located in the midwestern United States, and only in joint venture partnerships with its sponsor, Melvin Simon & Associates, Inc. as developer.

One limitation the format imposes is that REITs cannot be "dealers" holding developed property for sale, as in the case of, say, a single-family home builder. Even so, the flexibility of the format does not prevent a REIT from profiting indirectly from that sort of activity when the opportunity arises. In 1978 the portfolio of Federal Realty, for example, was about 60% shopping centers and 40% apartments; today management describe the portfolio a shopping center REIT which still owns one apartment complex. A quick sell off of apartments in the mid 1980s resulted from an unforeseen market opportunity for windfall profits. Though REIT limitations prohibited the company from converting these apartments into condos, inflation and tax changes in the mid-1980s stimulated such conversions and drove up the demand for apartment assets. Federal elected to sell their apartment holdings earlier than originally planned to take advantage of the inflated prices offered by condo converters. Thus the REIT format still allowed Federal to profit from trends in the changing market, but left the prohibited retail sales activities to the buyer. Such creativity permits REITs to take advantage of almost any market opportunity available to other real estate concerns.

<u>Unique Market Opportunities</u>

Because a REIT is motivated by different tax and financial objectives it can sometimes structure property transactions that would not be feasible to other developers or investors. Using Federal Realty again as an example, prior to 1986 the company would, in effect, package and sell off depreciation deductions to buyers that were taxable entities, because REITs were unable to pass through to shareholders the benefits of the losses which, prior to the Tax Reform Act of 1986, were deductible from regular income. The REIT format allowed shareholders to realize the value of those tax losses, although indirectly.

More recently, Federal Realty acquired control of seven shopping centers through a 49-year leasehold rather than a fee-simple purchase. The lessor was an older individual who wanted to dispose of the property but avoid the capital gains and estate taxes that would be levied on the proceeds of a sale. Competing buyers would have preferred to purchase property, with leverage, and use the interest payments and depreciation expenses to reduce taxable income. Because REITs are not required to pay taxes, Federal could evaluate this transaction solely on a cash-flow basis. (REITs are required to distribute 95% of net taxable income but are actually able to distribute up to the entire before-tax cash flow.) Upon settlement of the seller's estate, Federal Realty's management anticipates buying the property outright (prior to the end of the lease) and intends to exercise its redevelopment and expansion strategies on the leased properties, just as if they were owned.

Disadvantages of the REIT Format

<u>Barriers to Entry</u>

Firms that wish to establish a new REIT face substantial barriers to entry. Initial Public Offerings (IPOs) are very expensive and complex procedures, much more expensive than subsequent equity offerings. Underwriting, printing, and other costs for IPOs run about 14% to 15% of the total offering amount; compared to 5½% to 6% for subsequent common equity offerings.[9] Further, once new securities reach the market, most tend to quickly fall below their original offering price. Of 17 initial public offerings in 1985, only three were trading above their original price one year later.[10] ICM Property Investors' common stock, for example, has never traded above the 1985 initial offering price of $20.00 per share. From a financial management standpoint, no additional equity offerings can take place until after this period of depressed value has passed. Typically, a stock must demonstrate a track record of performance before new investors will support another offering.

<u>Operational Expenses</u>

Aside from start up costs, routine operating expenses are also high. Operating a REIT requires an additional layer of management beyond the scope of a traditional private development company. As a result of these high inherent fixed costs, another crucial factor in setting up a REIT is size. The smaller REIT in public form is a very costly way to do business. There are smaller trusts, but most industry analysts believe that without a threshold of about $100 million in assets[11], it is disproportionately expensive to produce SEC reports, quarterly shareholder reports, and an investor-communications program. These overhead expenses must be compensated by higher project returns.

Stock Market Valuation

Another potential stumbling block for new and established REITs alike is that the performance criteria of the stock market may conflict with the real estate market. Ideally, the price of a real estate equity security should simply reflect the value of the underlying securitized real estate; this is seldom the case. While it is true that dividend income streams relate directly to the cash flows earned by the held real estate, REIT shares are truly hybrid securities whose price movements correlate highly with those of the stock market.[12] REIT management may identify attractive development opportunities at a time when its stock values are depressed for reasons unrelated to the real estate market or value of assets. At the end of 1989, for instance, the appraised value per share of Copley Properties was $22.04 while each share traded for about $12.00. So, in a public offering, Copley would have received about $0.54 for each dollar of their real estate portfolio sold. Obviously, this situation impairs the REIT's ability to raise capital in a timely manner.

Constant Capital Requirements

In order to grow, a REIT must become a constant consumer of capital. Due to the requirement that REITs distribute 95% of taxable income, growth must be accommodated through new capital as opposed to utilizing retained earnings, which would be much less costly. So, even though the cost of capital may be lower, the frequency with which a REIT must buy capital is higher than some of its competitors.

Dependence on Cash Flow

For a REIT to have access to the capital markets it must maintain a favorable stock performance, in terms of growth and income. Traditional developers can and will tolerate negative cash flows associated with the construction and lease-up periods of a project in anticipation of favorable long-term returns. Certain shareholders may understand the rationale behind such a strategy, but the stock market at large will not tolerate decreasing dividends for any length of time. This intolerance is reflected in lower market value of the stock. Joint Venture REITs, in particular, must either endure depressed stock values during development periods or find alternate sources of income to offset the low cash flows.

Limitations on Capital Structure

Like other development entities REITs can take on debt, employing leverage to enhance returns. Debt is less costly to a REIT in the short run due to lower underwriting costs, and in the long run interest payments are generally less costly than dividends. But leverage equates to risk; if REITs employ too much debt then the market will discount the value of the stock to offset the risk of leverage. Lower stock prices limit the REIT's ability to borrow and to raise additional equity capital. The market, specifically rating agencies, can effectively limit the acceptable debt-to-equity ratio for a REIT. Federal Realty, one of the most highly leveraged public REITs, maintains an ongoing dialogue with rating agencies, such as Standard and Poor's and Moody's. Federal's management claims that agencies' threats of lower ratings are a major influence to raise additional equity. If a rating agency lowers its grade, a stock's market value will likely fall, resulting in a higher cost of equity, and thus offset the advantage of leverage.

Limitations on Portfolio Turnover

To insure against speculative and short-term trading,no more than 30% of a REIT's gross income may be gains from the sale of property held for less than four years (excluding gains from foreclosure). There are occasions, often unforeseen, when an early sale of a project may be in the best interest of the shareholders. This restriction can hinder a REIT's ability to maximize profits. Gains from such disallowed transactions are taxable and forfeited 100% to the IRS. The alternative to the stiff payment is to surrender REIT status.

Takeover Risks

Because security values typically trade at a discount from the fair market value of the underlying real estate, REITs are susceptible to hostile takeover attempts by other real estate investors. There are certain strategic covenants that REITs can employ to protect against large volume stock purchases. For example, provisions can be built in to the organizational documents to restrict the transfer of shares, so that 50% of the outstanding shares cannot fall into the hands of five or fewer individuals. Some REITs reserve the right to issue special preferred stock, enabling the company to place a large block of voting shares into friendly hands.[13]

In summary, the sum total of advantages and disadvantages of pursuing real estate development through the REIT vehicle is positive only under certain circumstances. Running a real estate business and running a publicly held corporation present management with conflicting goals. The business of real estate development requires construction capital outlays at the front end, relentless debt service payments, no rental income during the development period and limited income during the lease-up period. After a ride on that roller coaster, the developer's desired end result is a steady stream of cash flow from a fully operating structure, whose value is worth more than its original cost. To reach the desired end, developers must tolerate low or negative cash flows, now, for attractive income streams later. Developers are accustomed to that trade off; common equity shareholders are not. The business of running a publicly held income-oriented development corporation (a value-creation REIT) requires a steady stream of increasing cash flows. This implies a paradox that would make "real estate development" and "publicly held securities" seem mutually exclusive.

The market for income stocks demands immediate gratification in the form of dividends, or distributions per share. Investors will pay more for a proven source of dividend income, raising the market price of the stock. If the value-creation REIT is to serve as a well from which to draw capital, the value per share must be enhanced over time, or the well may run dry. Chapter Three will illustrate that this was largely the case among the Joint Venture case study REITs. If share value is to be maintained, REITs involved in the development process must find ways to supplement inherent negative cash flows. This is especially true in an uncertain leasing market. The Acquisition and Development REITs have relied on large portfolios of existing properties to fund dividends and cash drains of renovation projects.

Development as a REIT: Two Approaches

The REITs chosen for this analysis were selected to illustrate the various ways that the REIT vehicle can be used to facilitate the development of real estate. There are two notable basic strategies: the joint venture equity partnership with independent developers, and the strategy of acquisition, redevelopment and/or expansion of existing built property. Some REITs employ a combination of both strategies, but the companies selected for study have historically demonstrated a preference for one approach over the other. The remainder of this chapter, as well as Chapter Three, will focus primarily on the six case studies profiled in Exhibit 2.3.

Within the context of these two fundamental investment strategies there are a variety of ways that individual REITs can further differentiate themselves from one another. The important characteristics of a REIT's individual strategy include the type and diversity of investment property; the size of the real estate portfolio; the percentage of the portfolio under development at any one time; the capital structure or use of leverage; and the means employed to access new debt and equity capital. Logically, age of the REIT will also have an impact on the portfolio size-- building a portfolio of real estate takes time. Further, the climate of the real estate market at the inception of a REIT may have had significant influence on the chosen development agenda.

EXHIBIT 2.3: THE CASE STUDY REITS

JOINT VENTURE EQUITY PARTNERSHIP REITS

Name of REIT:	Year Founded:	Real Estate Portfolio:	Capital Structure:	Description:
Copley Properties, Inc.	1985	$68,098,507 Assets 12 Properties Warehouse 73.7% Office 11.6% R&D 10.4% Residential 4.3%	Debt-to-Equity 0.1:1 Debt 8% Conv. Debent. 0% Equity 92%	Company invests in to-be-built properties with a number of developers as an equity partner or a lender with an equity option in the completed project. Projects are located in several geographically diverse markets in the U.S.
ICM Property Investors Incoroporated	1985	$131,077,000 Assets 11 Properties Office/R&D 100%	Debt-to-Equity 1.0:1 Debt 51% Conv. Debent. 0% Equity 49%	ICM invests as a general partner in joint venture partnerships with a number of developers in geographically diversified markets. The trust wholly owns two properties. Presently negotiating a stock-for-property purchase of an existing industrial portfolio.
MSA Realty Corporation	1984	$79,410,043 Assets 18 Properties Shopping Centers 100%	Debt-to-Equity 0.7:1 Debt 27% Conv. Debent. 15% Equity 58%	The company invests as a general partner in joint venture partnerships with Melvin Simon & Associates,Inc., exclusively. MSA typically contributes all of the capital required by each joint venture to develop, acquire and/or expand a shopping center. The company has right of first refusal to invest in any properties Melvin Simon & associates proposes to acquire or develop.

Sources: 1989 annual reports and NAREIT Fact Book.

EXHIBIT 2.3: THE CASE STUDY REITS (continued)

ACQUISITION AND DEVELOPMENT/REDEVELOPMENT REITS

Name of REIT:	Year Founded:	Real Estate Portfolio:	Capital Structure:	Description:
Federal Realty Investment Trust	1962	$514,552,000 Assets 43 Properties Shopping Centers 99.1% Apartments .9%	Debt-to-Equity 2.9:1 Debt 46% Conv. Debent. 28% Equity 25%	Federal invests primarily in prime community and neighborhood shopping centers. The redevelopment strategy is to upgrade older centers in prime locations through reconfiguration, expansion and modifying tenant mix. The company does its own property management and leasing.
IRT Property Company	1979	$150,455,715 Assets 71 Properties Shopping Centers 88% Apartments 9% Industrial 2% Other 1%	Debt-to-Equity 1.3:1 Debt 44.0% Conv. Debentures 12.6% Equity 43.4%	Real estate investments consist principally of neighborhood and community shopping centers, located in the Southeastern United States and anchored by major grocery, drug and variety stores. IRT renovates, expands, manages and leases acquired properties. The company also participates in development as a construction lender on new projects. IRT oversees design and construction, participates in anchor tenant lease negotiations and controls leasing standards and rates.
New Plan Realty Trust	1962 REIT Since 1972	$116,518,612 Assets 59 Properties Shopping Centers 60% Cash and Securities 25% Apartments 6% Real Estate Securities 5% Other Real Estate 4%	Debt-to-Equity 0.1:1 Debt 8.7% Conv. Debentures 0.3% Equity 91.0%	New Plan Realty Trust evolved from New Plan Realty Corp., a pooled real estate investment vehicle founded by Morris B. Newman that first went public in 1962. Newman family members still direct the REIT, which is primarily an equity owner of fee and leasehold interests in income producing real properties.The investment strategy is to purchase seasoned well located shopping centers and apartment complexes, at a discount to replacement costs, and seek to achieve income growth through a program of expansion, renovation, re-leasing and/or re-merchandising.

Sources: 1989 annual reports and NAREIT Fact Book.

The Joint Venture REITs

1985 was a record setting year for the REIT industry. With 29 initial public offerings totaling $ 2.9 billion, industry followers nicknamed this group the Class of '85. REITs had become quite popular and the real estate development business was booming. In this thriving mid-1980s market, all three of the Joint Venture REITs issued their initial public stock, each without the benefit of an established real estate portfolio.

Traditional equity REITs invest in proven, existing income-producing property. Most of the underlying value of their stock is attributable to cash flow generated from the steady flow of rental income, less operating, investing and financing expenses. Unlike traditional equity REITs, development REITs set out to capture the value created immediately when a new building leases up, making the transition from a construction project to a cash flow generator. To achieve the desired results the Joint Venture REITs rely on the expertise and abilities of the developer partner to identify the opportunity, build, lease and manage the project. As a money partner, the REIT can monitor and influence these efforts but they are clearly not internal functions of the company.

Copley Properties, Inc.

Copley Properties typifies the general strategy representative of this group. Its founders envisioned that the underlying value of the common stock would increase as a result of increased asset value realized through the development process. At the outset, management specifically targeted real estate development as a key part of their investment strategy. Funding real property in its development phase, they reasoned, would enable Copley to invest at the cost of raw land and improvements rather than at the retail price, or fair market value of fully developed real estate. The Company anticipated that the resulting appreciation would enable it, through refinancings, to invest additional capital in future development projects while retaining its interests in the original deals. The bylaws of the company were set up to limit the use of leverage to no more than 300% of the net book assets. The Copley prospectus represented that sale of each property would generally occur between 8 and 12 years after the original investment. REITs are prohibited from "flipping" property or acting as dealers by the 30% Income Test (as described in Chapter 1), but Copley anticipated long-term profit from appreciation would be realized through capital gains.

The investment strategy chosen for the REIT was intentionally identical to the investment strategy successfully employed by the advisor, Copley Real Estate Advisors, Inc., since its inception in 1982. The REIT format was chosen to provide a market for small investors to participate in the same sort of investments that had been previously available only to pension funds and institutions. At the inception of the REIT in 1985, the advisor also believed that securitized real estate was an important area for the company to diversify into. In addition, management of the REIT served as a source of fee revenue for the advisor.

Capitalization of the joint ventures is typically in the form of a construction loan at the beginning of a project with an option to acquire an equity position when the building is completed. In a routine example, Copley would loan $10 million to construct an 80,000-square foot office/R & D building and at the same time, for $100,000, purchase an option to acquire a 60% limited partnership when the building was completed. Excercising the option and buying the partnership position would cost another $2 million. Interest on the construction money and equity returns ran at about 12%. Copley also funded development buy purchasing land and then leasing it back to the seller, with ground rent based on a fixed amount plus some portion of the gross receipts. In a typical 60-year lease, ground rent base payments resembled debt service amortized at about 12%, and additional rent equaled 50% of gross rental reciepts after rent payments.

ICM Propety Investors

The strategy for ICM Propety Investors was similar to that of Copley Properties. Although in their first year of operations, besides investing in joint venture development projects, ICM paid all cash to purchase two new office buildings, independently. (The seller assumed the risk in the lease-up period and gauranteed a minimum level of cash flow by "master-leasing" the entire buildings for three years.) ICM categorizes their two types of joint venture partnerships as "mortgage-equity" joint ventures and "equity gap" funding joint ventures. In the former, ICM as a general partner provides first mortgage financing and an equity contribution to the partnership holding the real estate. In an equity-gap joint venture, the company and a developer form a partnership with each party as a general partner. To this partnership, the developer contributes the property, subject to existing third party financing, and ICM makes an initial equity contribution in exchange for a preferred interest in the venture. ICM stipulates that its own required return must be paid before any funds are distributed to the developer-partner. ICM also has a priority interest in the sale of the property. In an effort to boost lagging cash flow ICM is presently negotiating a stock-for-property purchase of several existing industrial properties from a west coast developer. This will be discussed further in later chapters.

<u>MSA Realty</u>

MSA Realty provides an important contrast to the other Joint Venture REITs, for two reasons. First, the company invests in community shopping centers and regional malls, as opposed to office and industrial properties and second, the sponsor of this REIT is a developer. In fact, three wholly owned subsidiaries of Melvin Simon & Associates provide staff for the REIT's entire scope of operations: the investment advisor, the development company, and the management company. All MSA projects are developed by

Melvin Simon & Associates and the REIT has had right of first refusal to participate in any project undertaken by the sponsor. Projects are funded by the REIT through capital contributions or by guarantees of construction loans; MSA routinely provides all capital required by a joint venture in exchange for preffered returns during the construction period and an equity postion in the finished product ranging from 42.5% to 50%.

MSA was founded in 1984 with the stated intention of qualifying as a REIT, but due to an excess of short-term investments, did not attain REIT status until the 1987 tax year. After six years of limited leasing success, the company is presently trying to liquidate and again may face disqualification as a REIT. Nevertheless, the company has participated in the development of 18 community shopping centers, each one a seperate joint venture partnership with the same developer, totaling over 4.5 million square feet of space, significantly more than the other two Joint Venture REITs studied. MSA's leasing difficulties and cash flow shortages (presented in the following chapter) illustrate that the recent problems in the real estate market were not limited only to office and industrial properties. Historically, the older equity REITs with concentrated retail portfolios, like Federal Realty and New Plan, have weathered previous recessions comparatively well.[14] MSA's short history would indicate that concentrated retail holdings, alone, do not insure success.

The Acquisition & Redevelopment REITs

> *"Renovations and modernizations do not automatically create additional income - this must come from new leases. Our expansion programs must be complete and paid for before these stores can be leased and produce income. Although future cash flows can be expected and the portfolio enhanced by these additions, increases in cash flow from these programs may not be immediately reflected."*
>
> Donald MacLeod, Chairman of IRT Property Company (1989, Annual Report to Shareholders)

These companies invest primarily in shopping centers, some with diversification in apartments and industrial properties. Renovation efforts generally happen immediately after the acquisition of a property and, for a typical community center, can be completed within a year. Reconfiguration can be quite extensive, phased if necessary, with substantial additions to rentable area. Upon completion, these projects are indistinguishable from new construction. Then the second part of the strategy is to re-tenant the space with those merchants that will attract the most business.

While the Joint Venture category of REITs each started their operations from scratch with a stated strategy to build the portfolio through development, the Acquisition & Redevelopment REITs typically evolved into active developers, adding value to purchased properties through renovation. Development strategies in this group grew out of day-to-day management activities of existing income properties. Owners realized that, if the location was right, aesthetic and functional improvements to an older shopping center would attract better retail tenants and generate higher rents. The acquisition price of an older shopping center, or apartment complex, would be substantially lower than the market value after renovation, expansion, and re-tenanting. Typically, the companies in this category follow an investment strategy focused on building and holding an income-producing portfolio; development and redevelopment efforts are a supplemental means to that end.

Some of these REITs have, in addition to their renovation and expansion efforts, ventured into ground-up development of new projects. Weingarten Realty Investors, for example, holds vacant land in their portfolio with the expressed intention of constructing new retail centers as market conditions permit. IRT, through joint venture partnerships with developers, has built new shopping centers and taken an active role in overseeing their design and construction. United Dominion also has independently developed new industrial buildings from the ground up. Federal Realty added a 5-story hotel on the site of their 275,000-square foot Grovenor Plaza. Hotel operation is forbidden by a REIT, so the company structured a ground lease for that portion of the site. Also, it receives all rental income from the 10,000-square feet of lobby retail.

Development, redevelopment, and market repositioning activities all add value to the properties. Within this group of REITs, however, that value is usually passed on to shareholders through dividend income from higher rents, rather than gains from higher sales prices. This bias toward cash flow and long-term ownership over disposition transactions distinguishes the A&R REITs from the Joint Venture group in another way. These REITs employ their own property management forces, rather than relying on a development partner to handle initial leasing and management. In August 1988, for example, when New Plan absorbed its long-time independent agent, it became the first listed REIT to be self administered and self-managed. Ironically, the very first REITs of 1960 were established by property management companies, with themselves as independent contractors. Yet it was not until New Plan's conversion that the IRS formally recognized property management as an integral function of real estate ownership, and thus permissible by a REIT. In 1989 and 1990 respectively, Federal Realty and IRT Property Company each received Private Letter Rulings from the IRS to directly self-manage their properties. Federal Realty's extensive internal operations include separate divisions in Leasing, Marketing, Development, Property Management, and Acquisitions. Even in cases where management is, or was, handled through independent contractors, the relationship is usually very close and exclusive of any other management clients.

Other Applications of REITs in the Development Process

There are other REITs that participate in the development of property and offer unique differences worthy of mention, even though they fall outside my proposed typology. Property Capital Trust (PCT), for example, represents another strategy that is very similar to those of the listed joint venture group. Since the late 1960s this equity REIT has worked in close contact with developers on certain new projects for addition to the portfolio. The key difference is that PCT has traditionally avoided development construction risk and funded projects only upon approved completion, as a permanent lender or equity owner. Construction loans were funded from other sources. PCT also only funded these long-term investments subject to minimum occupancy so that the developer would bear the initial leasing risks.

REITs have been utilized in other ways, most notably by developers, to provide liquidity for their portfolio. Instead of raising common stock equity prior to starting development projects, some developers have established equity REITs to cash out of completed properties, while retaining a financial interest through the fee-generating management of the property. Through this strategy developers, who have traditionally done private placements rather than public offerings, gain a foothold in the public-securities market. Lincoln N.C. Realty Fund and Trammell Crow Real Estate Investors, for example, were designed to serve this purpose.[15]

Chicago Dock & Canal Trust is a unique development REIT that seems to deny classification. While it has entered joint venture partnerships with developers, this

REIT has assumed, on its own, some of the most challenging tasks of the process-- masterplanning, obtaining city approvals, and developing infrastructure for a major downtown development site. This trust is also unusual in that most of its assets are tied up in undeveloped or underdeveloped land. Chicago Dock's original land holding, a 46-acre tract that stretches along the north bank of the Chicago river, was assembled as a shipping and industrial hub 135 years ago, just prior to the Civil War. (Abraham Lincoln was one of the attorneys who helped structure the original land trust.) Today the site is remarkably well located in the city, bound on the west by the "Magnificent Mile," North Michigan Avenue, and on the east by Lake Shore Drive.[16]

Revamped in 1962 as an equity-oriented REIT, the closely held Chicago Dock did not move into the public investment arena until the mid-1980s when it tendered a 200-for-1 stock split to lower its share price and encourage more public trading. Shortly thereafter, the company announced plans to develop the old shipping pier area as part of Cityfront Center, a 60-acre, 12.5 million square foot mixed-use project to be fashioned after New York's Battery Park City. In a short-lived venture partnership with Equitable Life Assurance Society, the trust was primarily responsible for obtaining necessary masterplan and design approvals to redevelop the land and infrastructure. Chicago Dock and Equitable amicably divided the tract in 1986 and have developed their respective parcels independently but under the same master plan. Chicago Dock has used ground leases, fee sales, and joint venture partnerships with developers to create apartments, hotels, public open spaces and office space. Development of the tract is still underway. In addition, the trust has also acquired properties in Denver, Indianapolis, Tampa and Lansing, Michigan.

CHAPTER THREE

EVALUATING THE REIT AS A VEHICLE FOR DEVELOPMENT

> *"We were masters of poor timing. We are not recovering because we never had the opportunity to get started."*
>
> Arthur Viner, Chairman,
> ICM Property Investors
> (June 22, 1990)

Generally speaking, the Acquisition & Redevelopment REITs have performed more successfully over the last five years than those in the Joint Venture group. To warrant such a statement we must define the criteria by which to evaluate a value-creation REIT's success. There are four basic areas in which these REITs can demonstrate performance. These four areas can be thought of as steps in a cycle that a REIT must complete in order to succeed, *as a real estate security*, and grow. The steps are (1) the ability to raise capital; (2) the ability to put that capital to productive use, that is, to develop in line with its investment strategy; (3) the ability to generate cash flow, or to manage the properties; and (4) the ability to enhance shareholders' returns, or to maintain attractive performance as a security. Completing the fourth step enables the REIT to begin again at step one and raise more capital. Successful completion of each step in the cycle is dependent on completion of the previous step, and an equity REIT will grow in asset base and share value each time the cycle is completed. Perhaps the most crucial run through the cycle is the initial one. Since their inception in the mid-1980s, none of the Joint Venture REITs have successfully completed their first full cycle. This chapter, with empirical data tracing the steps of the cycle, seeks to explain the plight of the Joint Venture REITs and, in contrast, the stronger performance of the Acquisition & Redevelopment group.

Some of the reasons for the difficulties faced by the Joint Venture group are not linked to their choice of the REIT vehicle. Specifically, the nationwide downturn in the commercial real estate market fell at a most inopportune time for these fledgling REITs. Given the real estate market's volatility in the last five years, it would be unwise to conclude that the use of the REIT for this particular development strategy is ineffective. Market conditions have caused many of the problems.

The overbuilt condition of U.S. real estate markets has not changed dramatically over the past two to three years. Commercial real estate vacancy rates remain at distressingly high levels for most regions of the country. Due to reductions in new construction, areas with the highest vacancy rates have improved slightly, but real turnarounds have yet to occur. Even in those areas with expanding economies, development activity is still low because the supply of commercial real estate continues to outpace absorption of vacant space. The impact of these high vacancy rates has flattened or depressed effective rental rates as owners have competed aggressively for tenants. High vacancy rates have also placed a premium on property which is significantly leased versus development projects.[17] Even if new leasing efforts are successful, cash flow may be delayed due to expensive rent concessions, including free rent, now common in the marketplace.

The Joint Venture REITs all started operations at the crest of a wave of real estate development, and they have been operating in the declining market ever since. Compared to the Joint Venture group, the Acquisition & Redevelopment REITs entered the present soft market with established portfolios, some of which include debt-free projects. With operating histories spanning 25 years or more, both Federal Realty and New Plan have survived major recessions, first in 1974-75 when many real estate markets were overbuilt, and second in 1981-82 when markets were tighter, aggregate construction volume was heavy, and user demand was strong.[18] This resilience could be attributable to the nature of the investment portfolios. The Acquisition & Redevelopment typically invest in low glamor, high utility retail shopping centers and apartments. The demand for consumer necessities and affordable rental housing remain generally constant, even during recessionary periods. Commercial office space, on the other hand, is more like a commodity. That is to say that, during periods of economic hardship, firms can contract by reducing staff or reducing office space per worker and thus cut down their consumption of space. As a matter of timing, many of the difficulties faced by the Joint Venture REITs can be attributed to their recent start-up followed soon after by depressed conditions in real estate markets.

Contrasting Track Records: Performance as a Security

Security returns, the last step listed in the cycle of REIT growth and success, are generally the first performance indicator the shareholder sees. Dividend yields and share prices are easily monitored in the newspaper, on a daily basis. The internal activities of the REIT that ultimately determine its security performance, however, are tougher to observe. Poor performance over time is a likely tip-off that the REIT in question has stumbled at some previous point in the cycle, as is the case with the Joint Venture group of REITs. Evaluation of security performance shown in Exhibit 3.1 indicates that over time the Joint Venture group have cut dividends; in turn, share prices have fallen and returns have been flat.

Another potential measure of a REIT's security performance is the value of each share relative to the proportionate fair market value of the underlying real estate. This information is more difficult obtain since the appraised value of the properties is published only at the REIT's discretion. Real estate securities generally trade at a discounted value from that of their real estate. This is not always the case, however. REITs that have demonstrated a particularly successful management track record and a history of attractive shareholder returns don trade at a premium. Based on their own appraisals, the market value of outstanding shares of New Plan Realty Trust, for example, was greater than the current value of

EXHIBIT 3.1 : ANNUAL SHAREHOLDER RETURNS OF VALUE-CREATION REITS

JOINT VENTURE REITS		1984	1985	1986	1987	1988	1989
Copley Properties, Inc.							
Share Price	$20.00 IPO,		$17.25	$18.38	$16.75	$17.00	$12.00
Distributions Paid	July 29, 1985		$0.69	$1.65	$1.68	$1.68	$1.50
Annual Return			-10%	16%	0%	12%	-21%
ICM Property Investors							
Share Price	$20.00 IPO,		$14.81	$14.38	$11.00	$9.44	$7.63
Distributions Paid	Jan. 25, 1985		$1.21	$1.39	$1.48	$1.36	$0.70
Annual Return			-20%	6%	-13%	-2%	-12%
MSA Realty Corporation							
Share Price	$9.00 IPO,	$9.00	$8.63	$10.81	$8.56	$8.38	$8.75
Distributions Paid	Apr. 5, 1984	$0.48	$0.84	$0.95	$1.00	$1.00	$0.60
Annual Return		5%	5%	36%	-12%	9%	12%

ACQUISITION & REDEVELOPMENT REITS	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Federal Realty Trust										
Share Price	$6.88	$8.50	$10.38	$12.50	$15.25	$17.13	$18.38	$21.00	$22.25	$24.00
Distributions Paid	$0.53	$0.59	$0.68	$0.75	$0.89	$0.98	$1.05	$1.11	$1.23	$1.36
Annual Return	18%	32%	30%	28%	29%	19%	13%	20%	12%	14%
IRT Property Company										
Share Price	na	$5.40	$6.37	$8.32	$9.52	$10.15	$13.50	$12.55	$14.50	$13.19
Distributions Paid	$0.41	$0.53	$0.63	$0.68	$0.75	$0.90	$1.16	$1.04	$1.10	$1.15
Annual Return	na	na	30%	41%	23%	16%	44%	1%	24%	-1%
New Plan Realty Trust										
Share Price	$3.71	$3.92	$5.09	$8.00	$8.50	$11.50	$13.75	$17.25	$14.75	$17.50
Distributions Paid	$0.30	$0.34	$0.39	$0.51	$0.57	$0.65	$0.73	$0.81	$0.89	$1.02
Annual Return	23%	15%	40%	67%	13%	43%	26%	31%	-9%	26%

Source: Annual reports and 10-Ks.

NOTES:

Share Price = Avg. 4th Quarter Closing Price

Distributions Paid = Total annual dividends for calender year.

$$\text{Annual Return} = \frac{\text{(Change in share price from previous year + Distributions)}}{\text{Previous year's share price}}$$

Prices and distributions have been adjusted to reflect stock splits where necessary.

Initial year of operations are calculated assuming purchase at IPO and sale at 4th quarter.

the real estate in 1987 and 1989. In contrast, Copley properties trades at a significantly discounted market price, as shown in Exhibit 3.2.

Appraisal data is not available for each of the case-study REITs, but each of the Joint Venture REITs acknowledges that the asset value of its cumulative stock is substantially discounted from the value of its real estate holdings. For an equity REIT to enjoy the competitive advantage of "overvalued" stock they must demonstrate a long history of increasing returns. New Plan Realty Trust is one of the few companies that has been able to push the market value of their stock beyond the net worth of the underlying real estate. This fortunate situation is found only among the older REITs which have demonstrated steady performance. Youth and perceived inexperience have been a disadvantage to the Joint Venture group of REITs (even though each of the sponsors themselves had considerable prior real estate expertise). Indeed, securities performance of the Joint Venture REITs have clearly lagged that of the Acquisition & Redevelopment group. The root of the valuation problem is poor income performance of the property. However, securitization (and the behavior of the market) compounds the problem for the lagging Joint Venture REITs by driving prices below the value of their property. Whereas, the market actually augments the value of older workhorse REITs like New Plan. Hence, the "leverage" of going public with the REIT vehiclecan be positive or negative. The remainder of the

EXHIBIT 3.2

SECURITIES MARKET PRICE vs. APPRAISED REAL ESTATE VALUE

(Dollars per Share)	1989	1988	1987
Copley Properties Inc.			
Market value:	$12.00	$17.00	$16.75
Appraised value:	$22.44	$23.37	$23.37
Premium (Discount):	-46.5%	-27.3%	-28.3%
New Plan Realty Trust			
Market value:	$17.50	$14.75	$18.10
Appraised value:	$16.67	$16.27	$17.25
Premium (Discount):	5.0%	-9.3%	4.9%

Source: 1987 - 1989 annual reports of each company.

chapter will examine the other steps of the cycle to explore the reasons behind these differences in performance.

Building the Bricks and Mortar:
Performance as Developers

Despite their poor performance as securities, the Joint Venture REITs did manage to develop real estate-- as they had originally set out to do. In fact, their success as prolific developers has since proven to be a detriment. All of the Joint Venture development REITs have faced difficulties leasing their newly completed space under weak market conditions. There are also key differences between development strategies of the two case study groups that explain the Joint Venture REITs' glut of unleased space. For one thing, the Joint Venture REITs relied primarily upon development property to be the foundation of their portfolios, while the Acquisition & Redevelopment group used development and renovation, in moderation, to add to an existing foundation of income properties. In short, the Joint Venture group developed too much too fast.

Third party participation in the development process is another factor. The Acquisition & Redevelopment essentially raise 100% of the capital, debt and/or equity, for a given development project and complete it for their own portfolio as 100% owners. In contrast, the Joint Venture REITs have been criticized for funding sometimes up to 100% of the development capital, through either construction loans, mortgages or equity contributions, in exchange for 50% to 60% equity partnership positions with the developer.[19] Nonperformance by the outside developer/partner represents an additional layer of risk faced by the Joint Venture REITs.

To highlight the two different approaches to value-creation, consider two shopping center REITs-- MSA Realty and Federal Realty. MSA began operations in 1984 with seven joint venture partnerships. By the end of 1989 the company opened 17 shopping centers with one still under development. Yet total assets on the balance sheet decreased from $98 million in 1984 down to $97 million at the end of 1989; some partnerships were sold and others lost value. (The capital structure of these REITs over is presented later in the chapter in Exhibit 3.8) In that same time period Federal Realty renovated only seven shopping centers of 23 acquired; assets increased four-fold from $133 million to $564 million. In terms of aggregate rentable area completed, MSA outperformed Federal Realty as a retail developer. The problems for MSA began after the joint ventures progressed from the construction phase (during which the company received guaranteed returns from the developer) to the early operational phase during which the centers were not fully leased.

MSA's structure and higher development volume brought another added cost not faced by the Acquisition & Redevelopment REITs-- development fees. The development partners used by MSA and some other Joint Venture REITs typically charge fees at the completion of the projects, above and beyond whatever equity returns they receive as joint venture partners. In the case of ICM Property Investors and Copley Properties, REIT management is motivated to negotiate a lower fee structure for their various independent developer/partners. This may or may not be true in the case of MSA Realty because one third of its board is staffed by officers of the developer, the *only* developer, receiving those fees. Similarly, property management is provided on a fee basis by another affiliate of Melvin Simon & Associates. If development is fee-driven, it is a potential abuse of shareholders' interests.

Exhibit 3.3 illustrates the higher risk exposure faced by the ambitious Joint Venture REITs. In their start-up years these companies operated with over half their portfolios under development. Deals were generally structured so the REIT would receive guaranteed returns during the construction and prescribed lease-up period. For an office building this could last from 24 to 36 months, depending upon how early the REIT committed to the project. As a result, initially the REITs were somewhat insulated from the effects of the softening market. In most cases, joint ventures generated lower cash flows after transition from the subsidized-return periods. The Acquisition & Redevelopment REITs, on the other hand, could complete a major renovation within the course of 8 to 24 months. In some cases work could be phased so that a

EXHIBIT 3.3
DEVELOPMENT AND RENOVATION ACTIVITY

JOINT VENTURE REITS	1985	1986	1987	1988	1989
COPLEY PROPERTIES, INC. (c)(d)					
Total Properties:	6	10	13	12	12
Under Development:	5	7	10	6	6
Total Square Footage:	2,012,000	2,981,000	4,201,000	4,235,000	4,068,000
Under Development:	1,171,000	1,914,000	2,887,000	1,931,000	1,474,000
Pct. Under Development:	58%	64%	69%	46%	36%
ICM PROPERTY INVESTORS (c)					
Total Properties:	7	10	10	11	11
Under Development:	4	5	0	1	0
Total Square Footage:	784,199	1,318,635	1,318,635	1,392,635	1,392,635
Under Development:	453,700	630,436	0	74,000	0
Pct. Under Development:	58%	48%	0%	5%	0%
MSA REALTY					
Total Properties:	7	12	13	18	15
Under Development:	5	7	4	6	4
Total Square Footage:	2,427,000	3,714,000	3,979,000	5,767,000	4,767,000
Under Development:	1,257,000	2,441,000	753,000	1,007,000	435,000
Pct. Under Development:	52%	66%	19%	17%	9%

SOURCE: Based on information and narrative accounts of development activity as presented in the annual reports and 10-Ks for each company.

NOTES: (c) Properties may consist of multiple buildings or office parks.
(d) Property under development also includes planned projects; and those completed, but still in budgeted lease-up period.

EXHIBIT 3.3
DEVELOPMENT AND RENOVATION ACTIVITY (continued)

ACQUISITION & REDEVELOPMENT REITS	1985	1986	1987	1988	1989
FEDERAL REALTY TRUST (a)					
Total Properties:	26	31	34	41	42
Under Development:	5	2	3	3	3
Total Square Footage:	5,650,000	6,895,000	7,246,000	8,620,000	8,936,000
Under Development:	1,442,000	812,000	974,000	778,000	749,000
Pct. Under Development:	26%	12%	13%	9%	8%
IRT PROPERTY COMPANY (b)					
Total Properties:	31	55	66	68	68
Under Development:	3	3	0	1	3
Total Square Footage:	3,112,261	4,484,000	5,700,500	5,692,000	5,418,000
Under Development:	388,753	405,000	0	480,120	161,284
Pct. Under Development:	12%	9%	0%	8%	3%
NEW PLAN REALTY					
Total Properties:			35	39	46
Under Development:			6	6	4
	(Data not available)				
Total Square Footage:			4,500,000	5,272,000	6,250,000
Under Development:			94,200	692,300	638,000
Pct. Under Development:			2%	13%	10%

SOURCE: Based on information and narrative accounts of development activity as presented in the annual reports and 10-Ks for each company.

NOTES: (a) Includes retail portfolio only.
(b) Includes non-residential, equity investments only.

shopping center was still producing rent during construction. These different approaches in development account for the differences in cash flows described below.

Management Ability: Performance Measured Through Cash Flow

Management of a REIT is a significantly more complex task than that of, say, a stock and bond portfolio. Real property is a tangible investment that requires active day-to-day management. This property management includes construction, leasing, repair and maintenance of quality and appearance. Whether handled in-house or through independent contractors, a REIT's ultimate responsibility is to monitor and manage these activities. As portfolio asset managers, REIT executives must also determine when and how much capital should be allocated to investment and development, and to which properties. All actions and decisions imposed upon the REIT, from initial business strategy to building maintenance, constitute management.

Perhaps a true measure of management ability would include a qualitative, and largely subjective, evaluation. For our purposes, however, we will use cash flow as a benchmark to compare managements and then discuss what factors might account for the differences. One could argue that the securities market takes a similar "bottom-line" approach and recognizes good management by the cash flow extracted from the real estate. Dividends are generally a consistent proxy for cash flow; a REIT distributes most of its cash, but dividends only reflect cash flowing out, not the sources. A REIT, for example, could take out a loan to cover dividend payments during temporary periods of high vacancy. The original source of a REIT's cash flow for any given year is also important information in understanding performance.

Defining Cash Flow: Sources and Uses

As REITs have been followed more widely, industry analysts have tracked cash flow, rather than earnings, as a more significant performance measure. "Earnings," or net income, is an accounting term that typically includes deductions of non-cash charges like depreciation, which have no effect on cash flow. As a measure of performance, earnings tend to understate a REIT's actual net rental income, particularly when there are large depreciation deductions. On the other hand, principal repayments of loans are not deducted from earnings. Thus, the conventional measure of stock performance, earnings-per-share, has little relevance when applied to real estate securities. For an equity REIT, the net operating income from the real estate holdings or "cash from operations" is a more significant measure of performance. Typically, REIT annual reports devote a great deal of verbiage to make this point to shareholders. The numbers are harder to track, however.

After a long period of debate, the National Association of Real Estate Investment Trusts (NAREIT) has yet to adopt a uniform definition of "cash from operations." The definition varies among REITs, but is generally defined as net income before gains on sales of real estate less non-cash items such as depreciation and mortgage amortization. Some REITs with particularly large portfolios, New Plan Realty Trust among them, would argue that gains on the sale of property are rightfully a component of operating activities, not investing activities, particularly if the REIT is large and routinely sells property. This issue is controversial. Some members of NAREIT feel that including gains from the sale of property as operational income provides a distorted picture of the business. For instance, a troubled REIT in the process of liquidation would show a handsome income from operations if such a measure included gains from sales.

Cash from operations, however, is not the only source of cash flow to a REIT. Money can be obtained through financing, either borrowings or equity placements. Purchase or sale of property also affects REIT cash flows. Following new regulations, REITs now provide a Statement of Cash Flow in their reports to shareholders. These statements group cash flows into three somewhat standardized categories:

> Operating Activities: Generally including all rental income, property related expenses like utilities, repairs and maintenance, real estate taxes and property management. Funds to and from joint ventures are also under this heading.

Investing Activities: Including investments in real estate and other assets, net of debt assumed; the purchase and sale of short-term investments; proceeds from insurance claims and other such investment cash flows.

Financing Activities: Including proceeds from issuance of shares, cash distributions paid to shareholders, borrowings and repayments, mortgage principal payments, issuance costs, and other financial cash flows.

Cash Flow Tells the Story

The tables in Exhibit 3.4 present information taken from the Annual Report Statements of Cash Flows for the case-study REITs. Exhibit 3.5, is a one-page summary with dividend coverage ratios, (cash from operations divided by dividends paid) presented for easier comparison of the REITs. The cash flow record holds evidence that the Acquisition & Redevelopment group have outperformed the Joint Venture REITs on the basis of cash flow. Two observations are particularly relevant. First, cash from operations has been sporadic but generally declining among the Joint Venture group, and thus accounts for their declining dividends identified earlier. With the exception of IRT (in 1989), all of the Acquisition & Redevelopment REITs recorded steadily increasing cash from operationsover the same period. Second, the level of cash from operations of the Acquisition & Redevelopment REITs has largely

EXHIBIT 3.4
CONDENSED ANNUAL CASH FLOW DATA

COPLEY PROPERTIES, INC. (thousands)	1986	1987	1988	1989
Net Income (Loss):	$5,438	$4,268	$3,771	$2,262
Adjustments to reconcile net income to net cash from operations:	1,083	2,945	3,149	3,333
Net Cash provided (used) By operating activities:	6,521	7,212	6,920	5,594
By investing activities:	(410)	(14,682)	1,551	9,578
By financing activities: (before paying dividends)	151	13,851	(1,334)	(9,056)
Distributions Paid:	(6,619)	(6,713)	(6,733)	(6,252)
Increase(Decrease) in Cash:	($356)	($331)	$404	($135)

ICM PROPERTY INVESTORS: (thousands)	1986	1987	1988	1989
Net Income (Loss):	$3,888	($5,198)	($4,113)	($1,753)
Adjustments to reconcile net income to net cash from operations:	(340)	8,019	2,925	4,293
Net Cash provided (used) By operating activities:	3,548	2,821	(1,188)	2,540
By investing activities:	4,040	(1,912)	(149)	(4,657)
By financing activities: (before paying dividends)	0	8,162	9,532	7,457
Distributions Paid:	(7,835)	(8,642)	(7,719)	(5,039)
Increase (Decrease) in Cash:	($247)	$429	$476	$301

Source: Annual reports and 10-Ks.

EXHIBIT 3.4
CONDENSED ANNUAL CASH FLOW DATA (continued)

MSA REALTY TRUST (thousands)	1986	1987	1988	1989
Net Income (Loss):	$3,213	$4,990	$68	($4,568)
Adjustments to reconcile net income to net cash from operations:	(2,198)	(4,745)	(2,864)	3,941
Net Cash provided (used)	-------	-------	-------	-------
By operating activities:	1,016	245	(2,796)	(627)
By investing activities:	6,145	(18,831)	30,887	21,677
By financing activities: (before paying dividends)	8,495	19,542	16,457	(10,354)
Distributions Paid:	(4,025)	(8,511)	(8,584)	(5,183)
-----------------------------------	-------	-------	-------	-------
Increase (Decrease) in Cash:	$11,631	($7,555)	$35,964	$5,513

FEDERAL REALTY INVESTMENT TRUST (thousands)	1986	1987	1988	1989
Net Income (Loss):	$14,916	$6,045	$9,274	$11,997
Adjustments to reconcile net income to net cash from operations:	(2,086)	12,285	9,187	7,462
Net Cash provided (used)	-------	-------	-------	-------
By operating activities:	12,830	18,330	18,461	19,459
By investing activities:	(102,643)	(84,075)	(6,813)	(35,143)
By financing activities: (before paying dividends)	84,438	95,957	(69)	69,545
Distributions Paid:	(12,286)	(14,260)	(16,788)	(19,174)
-----------------------------------	-------	-------	-------	-------
Increase (Decrease) in Cash:	($17,661)	$15,952	($5,209)	$34,687

Source: Annual reports and 10-Ks.

EXHIBIT 3.4
CONDENSED ANNUAL CASH FLOW DATA (continued)

IRT PROPERTY COMPANY

(thousands)	1986	1987	1988	1989
Net Income (Loss):	$10,055	$7,898	$15,117	$8,911
Adjustments to reconcile net income to net cash from operations:	102	5,024	(826)	4,976
Net Cash provided (used)	-------	-------	-------	-------
By operating activities:	10,157	12,922	14,292	13,887
By investing activities:	(100,199)	(2,849)	(403)	(13,400)
By financing activities: (before paying dividends)	80,890	24,403	3,698	2,452
Distributions Paid:	(11,856)	(12,864)	(13,283)	(13,973)
-------------------------------------	-------	-------	-------	-------
Increase (Decrease) in Cash:	($21,008)	$21,613	$4,303	($11,033)

NEW PLAN REALTY TRUST

(thousands)	1986	1987	1988	1989
Net Income (Loss):	$15,618	$17,966	$23,450	$27,111
Adjustments to reconcile net income to net cash from operations:	(114)	3,385	767	1,922
Net Cash provided (used)	-------	-------	-------	-------
By operating activities:	15,505	21,351	24,217	29,032
By investing activities:	(12,085)	(18,938)	(34,210)	(40,637)
By financing activities: (before paying dividends)	34,787	(37,889)	(48,698)	52,247
Distributions Paid:	(14,747)	(18,257)	(23,780)	(28,148)
-------------------------------------	-------	-------	-------	-------
Increase (Decrease) in Cash:	$23,460	($53,734)	($82,470)	$12,495

Source: Annual reports and 10-Ks.

EXHIBIT 3.5

CASH FLOW FROM OPERATIONS AND DIVIDEND COVERAGE RATIOS

JOINT VENTURE REITS (thousands)	1986	1987	1988	1989
COPLEY PROPERTIES, INC.				
Cash from operating activities:	6,521	7,212	6,920	5,594
Distributions Paid:	$6,619	$6,713	$6,733	$6,252
Dividend Coverage Ratio:	99%	107%	103%	89%
ICM PROPERTY INVESTORS:				
Cash from operating activities:	3,548	2,821	(1,188)	2,540
Distributions Paid:	$7,835	$8,642	$7,719	$5,039
Dividend Coverage Ratio:	45%	33%	-15%	50%
MSA REALTY TRUST				
Cash from operating activities:	1,016	245	(2,796)	(627)
Distributions Paid:	$4,025	$8,511	$8,584	$5,183
Dividend Coverage Ratio:	25%	3%	-33%	-12%

ACQUISITION & REDEVELOPMENT REITS (thousands)	1986	1987	1988	1989
FEDERAL REALTY INVESTMENT TRUST				
Cash from operating activities:	12,830	18,330	18,461	19,459
Distributions Paid:	$12,286	$14,260	$16,788	$19,174
Dividend Coverage Ratio:	104%	129%	110%	101%
IRT PROPERTY COMPANY				
Cash from operating activities:	10,157	12,922	14,292	13,887
Distributions Paid:	$11,856	$12,864	$13,283	$13,973
Dividend Coverage Ratio:	86%	100%	108%	99%
NEW PLAN REALTY TRUST				
Cash from operating activities:	15,505	21,351	24,217	29,032
Distributions Paid:	$14,747	$18,257	$23,780	$28,148
Dividend Coverage Ratio:	105%	117%	102%	103%

Source: Exhibit 3.4

covered their dividends paid. Two of the Joint Venture REITs, ICM Property Company and MSA Realty, have routinely distributed amounts greater than their cash received from operations. With a slightly cleaner bill of health, Copley properties shows funds from operations that cover or exceed distributions, although dividends have been reduced over time.

For a closer evaluation of cash flow performance compare the selected data for ICM Property Investors and New Plan Realty in Exhibits 3.4 and 3.5. While the two REITs are very different in their investment strategies and portfolio holdings, the comparison demonstrates the significance of cash flow sources. Dividend coverage ratios in excess of 100% indicate that Federal Realty consistently earns more than enough cash through real estate operations to cover dividend payout. In the case of ICM, however, cash flow from operations covered, at best, half of the dividends paid. Most of their positive cash flows did not come from the operating activities, i.e. real estate. Rather 75% to 100% of the incoming cash flow came through financing activities which, in this particular case, were primarily bank loans. In short, it would appear that ICM is using borrowed money to pay dividends. (New Plan's whopping $108 million financing activity in 1989 reflects the proceeds of a public offering.)

Disparity of Cash Flow Performance: Reasons Why

Each of the Joint Venture REITs has had to reduce their dividends as a result of poor cash flows from real estate investments. As outlined earlier, leasing newly developed projects has proven to be much more difficult than expected. If this is a reflection on management, then perhaps their most significant err was to start a REIT-- in 1985-- with no existing portfolio of income-producing properties, thereby bringing product on line into an overbuilt market. The choice of product types might also account for the differing performance records. Office and industrial projects, developed from empty land, take much longer than the renovation of existing shopping centers. Office and industrial properties have also been harder hit by recent soft market conditions than retail and residential holdings.

The number of projects under development at any one time is another potential factor explaining the Joint Venture REITs' reduced cash flows. Consider again, for example, Federal Realty and MSA Realty. Both invested in community shopping centers, but Federal demonstrated much higher cash flows over the six-year life of MSA. One key difference is the ratio of completed leased projects to those under construction in the portfolio. Federal manages a portfolio of 42 centers, some of which have been owned and generating income for as far back as the 1960s. From 1984 to the present, at any given point in time, typically one or two of those centers may be under substantial redevelopment. MSA Realty's portfilio is quite different; out of 18 total investment properties in 1988, eight (almost half) were either under development or completed within that year. By early 1990 almost all of the remaining MSA holdings not under development were still in the initial lease-up phase. The other Joint Venture REITs, with their office and industrial holdings, all faced equally severe market risks by having so much of their portfolios subject to lease-up during what turned out to be a depressed real estate market.

A Typical Joint Venture Tailspin

This actual example of an ICM deal illustrates the combined effect of the pitfalls faced by the Joint Venture REITs; an overbuilt market, developer/partner risk, and unforeseen cash calls. Maitland Colonnades, a four story, 252,000 square foot Florida office building, was a typical "equity-gap" partnership. In 1986, ICM contributed $250,000 in exchange for a 5% general partnership in position. The REIT agreed to fund up to $8.25 million, if needed, to cover any gaps above the third-party construction loan. As a partner, the REIT would receive an 11% preferred return on its equity (even during construction and lease-up), 50% of net cash flows above the preferred return, and 50% of any net proceeds from sale of the property. If the $8.25 million was not enough the developer was to commit up to $1.25 million. Then if the project needed still more cash, the developer and ICM would make equal contributions as required. That was the plan.

By the end of 1988, the REIT had funded its full $8.25 million commitment. The project had gradually reached 90%

occupancy, but concessions had substantially lowered effective rents; the partnership needed additional cash flow but the developer was unable to meet its commitment. ICM assumed the developer's obligation in exchange for a larger general partnership position. With each additional contribution thereafter, ICM negotiated the dubious privilege of greater and greater equity ownership. By the end of 1989 ICM was a "47%" general partner entitled to receive 91.75% of both the gain from sale and net cash flows above the preferred return.

On March 31, 1990 the Maitland partnership's $26.75 million construction loan came due. Unable to obtain permanent financing as of June 1990, ICM had been granted an extension and was involved in a "workout" negotiation with the construction lender. Terms could involve reducing the loan amount by placing a mortgage on one of ICM's other more stable properties. If an agreement cannot be reached, ICM stands to lose its interest in the property.

Problematic low cash flows from real estate of the Joint Venture REITs stemmed from a large proportion of newly developed property in the portfolio, additional funding to the joint ventures during lease-up, rent concessions in the lagging market, and completion of projects at a time of over supply in the market. The low cash flows, in turn, prohibited subsequent attempts to raise capital.

Raising Capital: Availability and Affordability

> *"When we started in 1985, I would have guessed that by 1990 we would have made three or four trips back to the capital markets, doubled our equity base, and trade at a share price of between $20 and $30."*
>
> Steve Anthony, President of Copley Properties, Inc. (June 20, 1990)

Due to declining dividends and the lagging value of their share prices, none of the Joint Venture REITs have been able to return to the securities marketplace for equity since their initial offerings. Some have added debt to their capital structure, through short-term lines of credit and refinancing of completed properties, but even access to debt could have been more advantageous with the benefit of stronger securities.

Over the last five years, consistent dividend records and strong annual returns have enabled the Acquisition & Redevelopment REITs to secure a variety of lower cost debt instruments, convertible debentures, and subsequent public equity offerings, as illustrated in Exhibit 3.6, which presents a summary of capital market activities. In addition to these major public and private offerings, each of the Acquisition & Redevelopment REITs added equity by issuing shares through automatic dividend reinvestment plans available to shareholders. Some of these REITs have also issued shares, rather than cash, to fund acquisitions.

Exhibit 3.7 graphically illustrates the changing capital structures of the six case-study REITs over the last 10 years. Through frequent access to the

EXHIBIT 3.6

CAPITAL MARKET ACTIVITY: ACQUISITION & REDEVELOPMENT REITS
12/31/84 through 12/31/89

REIT	Year	Approximate Net Proceeds	Description
FEDERAL REALTY	1989	$44,900,000	Common stock offering, 2 million shares at $24 per share.
	1987	$100,000,000	5.25% convertible subordinated debentures. Issued to European investors in Eurodollars, not registered with the SEC.
	1986	$49,000,000	8.65% Senior Notes
	1985	$40,000,000	8.75% Convertible subordinated debentures.
	Total:	$233,900,000	
IRT PROPERTY COMPANY	1987	$25,000,000	2% Convertible subordinated debentures, Eurodollar bond issue. (Actual cost of capital is estimated to be 7.8% to 8% dependent on time of redemption.)
	1985	$19,127,000	Common stock offering, 1,305,000 shares at $15.75 per share.
	Total:	$44,127,000	
NEW PLAN REALTY	1989	$110,000,000	Sold 6,315,000 new shares of common stock in a public offering and privately sold 1,100,000 shares to a British pension fund.
	1985	$66,700,000	8.375% convertible subordinated debentures.
	Total:	$176,700,000	

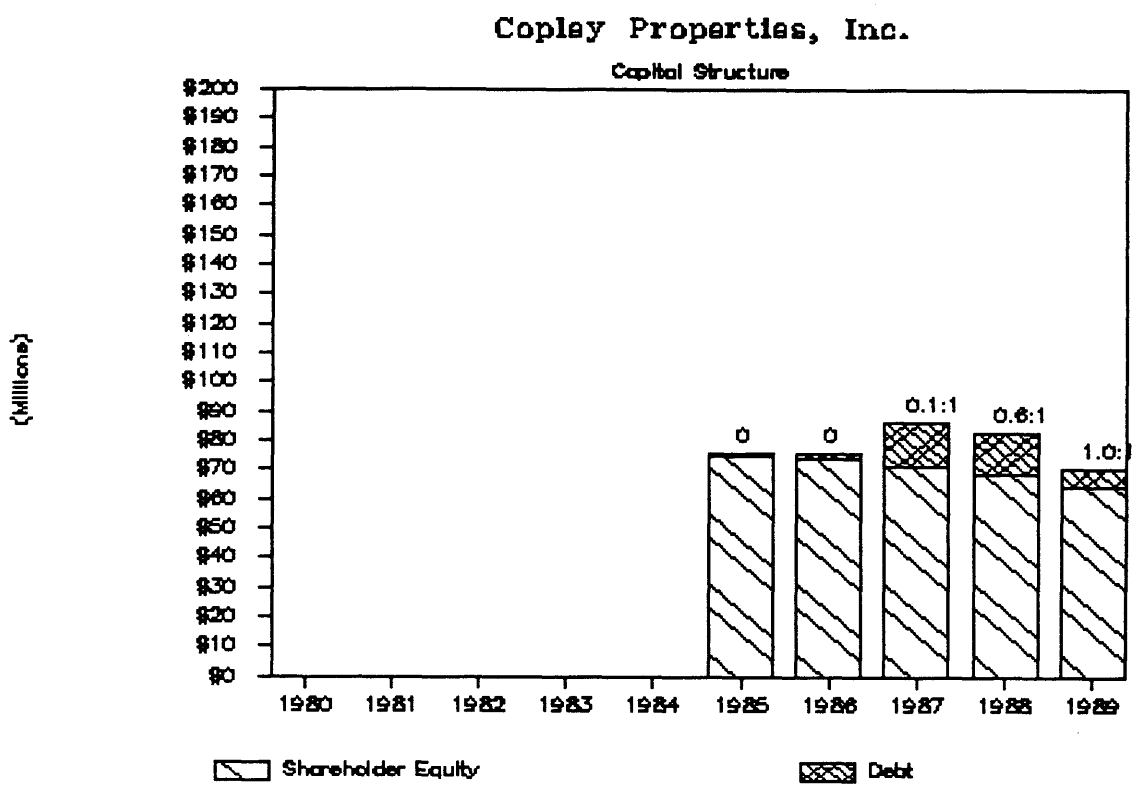
Source: Annual reports and 10-Ks.

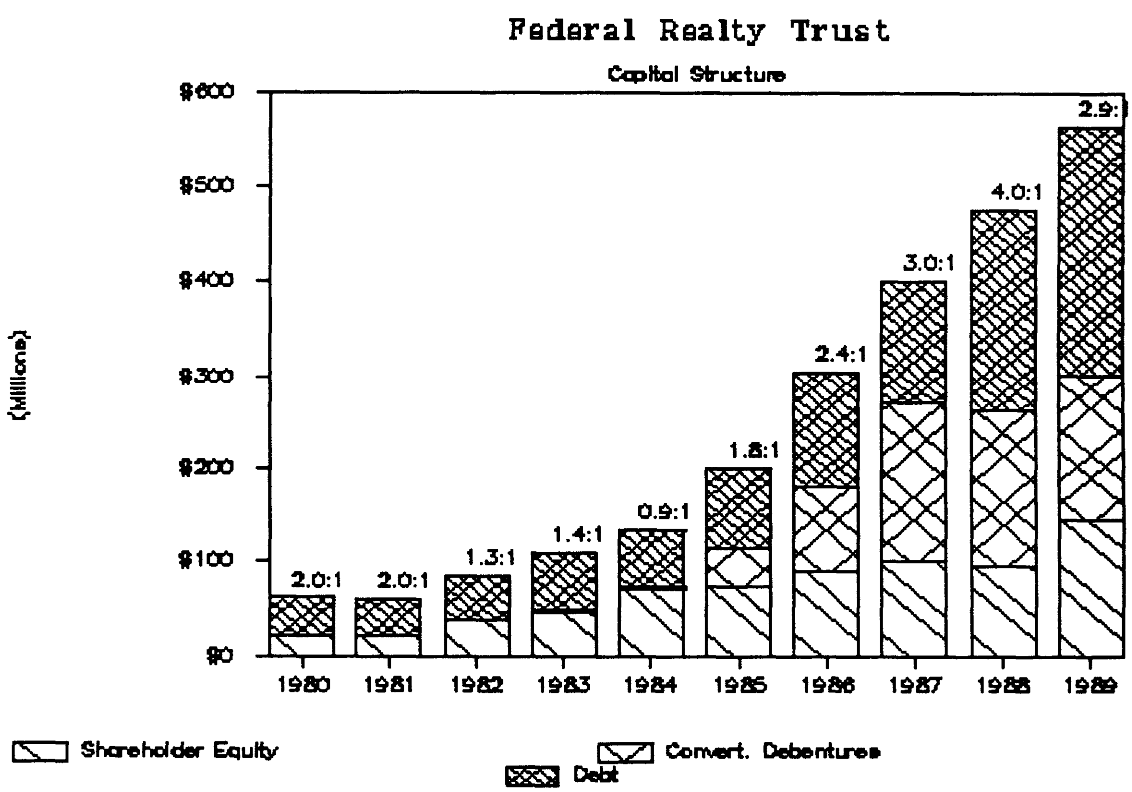
Major debt and equity placements only:
Does not include shares issued through dividend reinvestment plans.

capitalmarkets each of the Acquisition & Redevelopment REITs has increased its asset base and diversified its capital structure. During the last five years that brought such a challenging market for the Joint Venture group, the asset base for each of the three A&R REITs more than doubled. The charts also indicate that the level of shareholder's equity of the Joint Venture REITs has actually declined in recent years. This is a significant point since the dollar amount, not number of shares, has decreased. After paying dividends and additional capital infusions to joint ventures, these REITs have shown cumulative annual deficits which have depleted the level of equity. Obviously, if this trend were to continue, the shares could eventually become worthless in terms of book value.

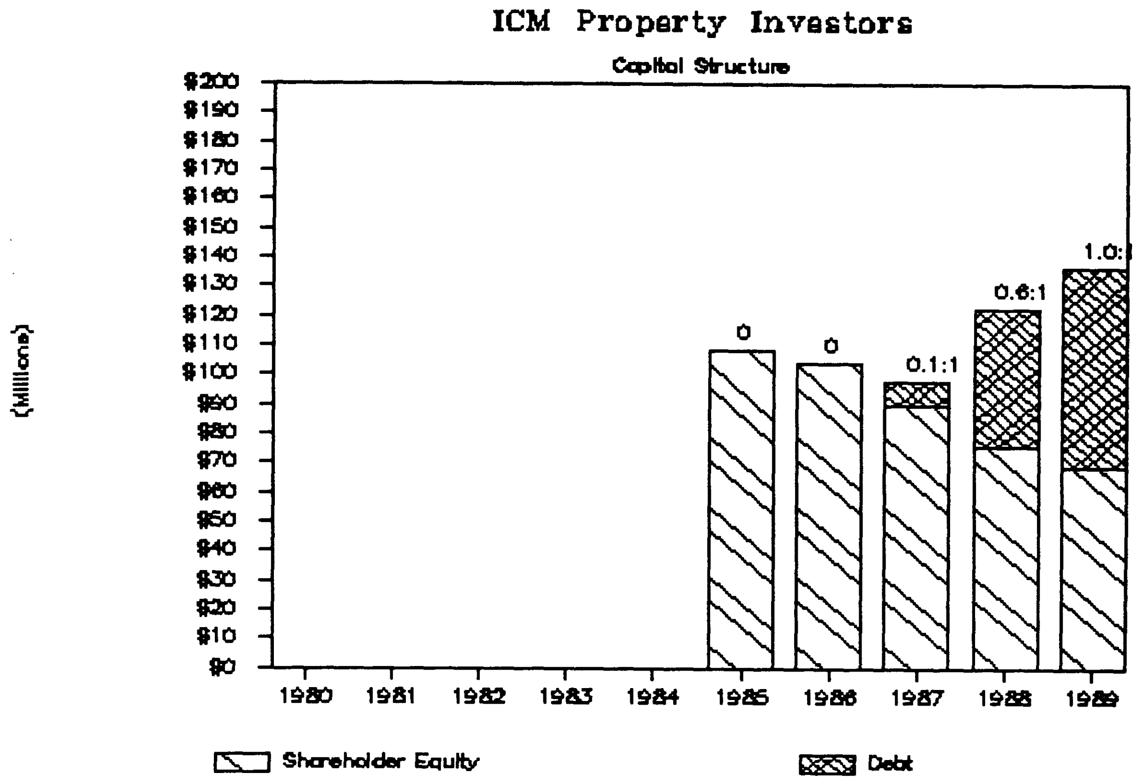
Debt Off of the Balance Sheet

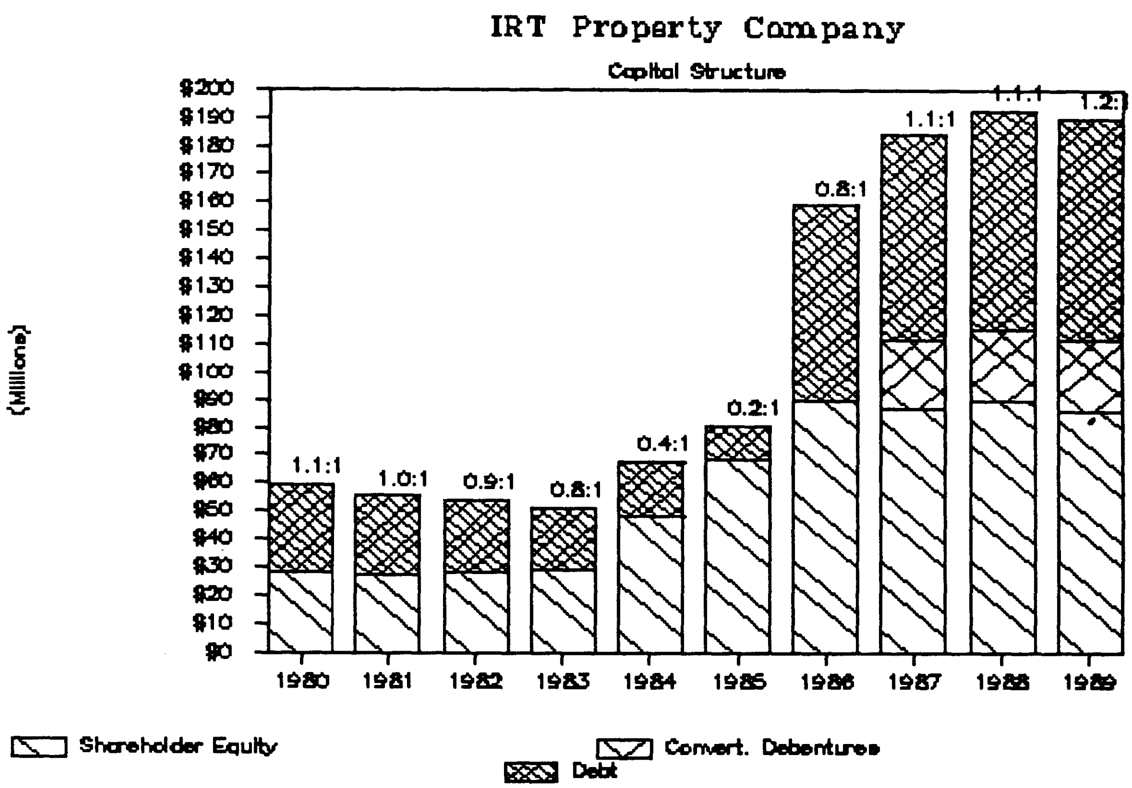
REITs that participate in joint venture partnerships may not reveal all of the debt used on individual properties. This is an important point to recognize when comparing the capital structure (as in Exhibit 3.7) employed by various companies. Debt can be incurred by the joint venture partnership, rather than the REIT itself. Of course, in some cases the REIT is the lender. The 1989 annual report data published by Copley Properties, for example, would indicate that the REIT is capitalized with almost all equity. Interviews with management revealed that the properties are also encumbered by debt incurred at



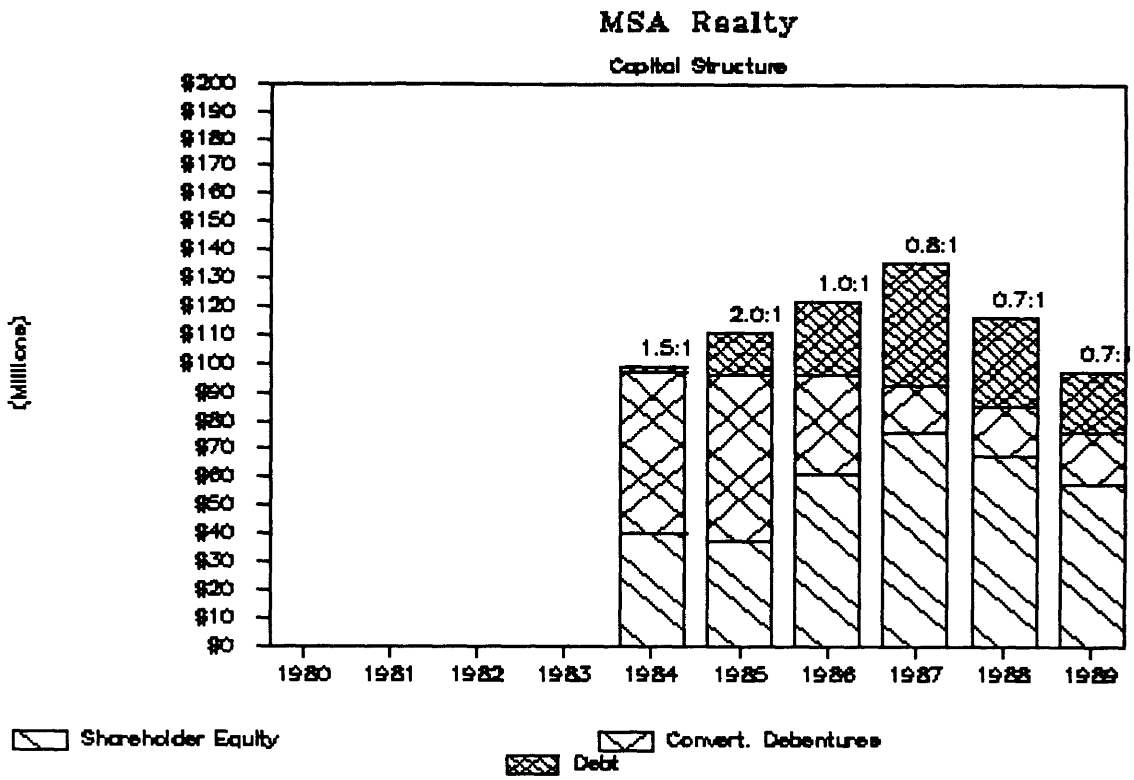


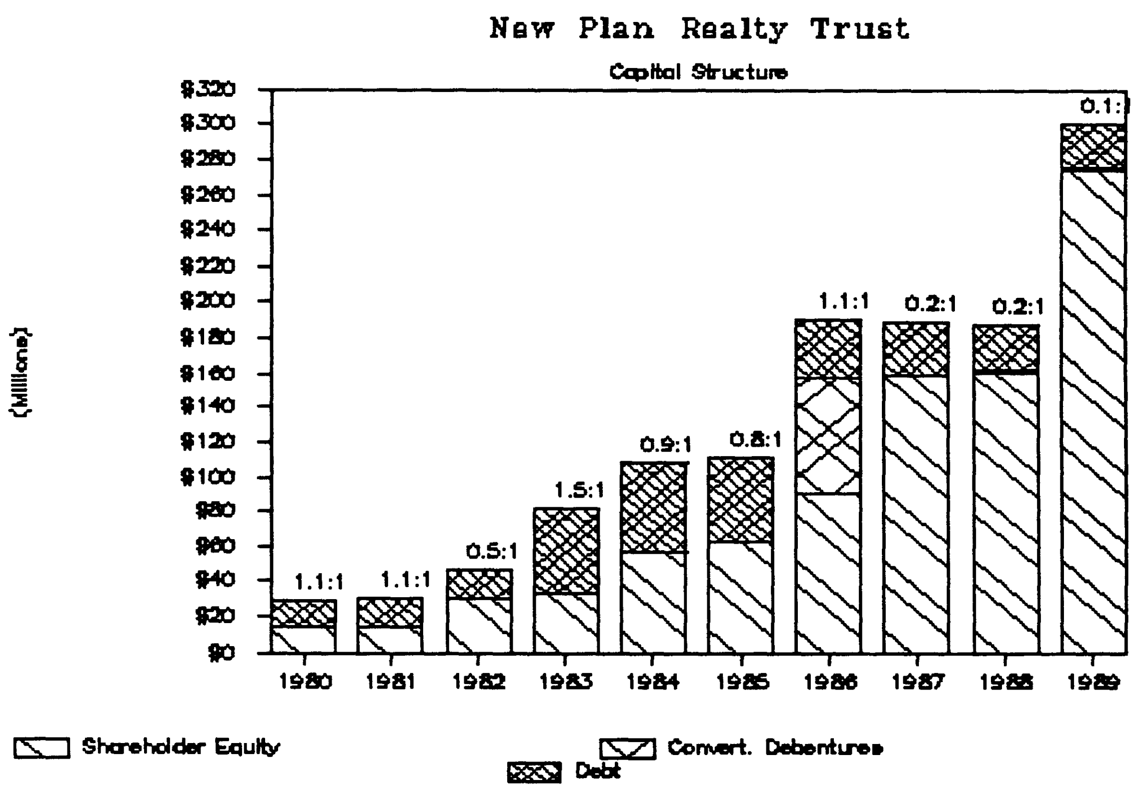
(Exhibit 3.7: Graphs of Changing Capital Structure)





(Exhibit 3.7: Graphs of Changing Capital Structure)





(Exhibit 3.7: Graphs of Changing Capital Structure)

the joint venture partnership level. In Copley's case, the outside debt was about $84 million in June of 1989. The point to remember is that corporate debt on the balance sheet does not nessecarily reflect the debt on the actual properties, especially in the case of the Joint Venture group of REITs. The disparity between debt on and off the balance sheet can distort a comparison of REIT capital structures. Since higher leverage equates to higher risk, the desire to conceal additional debt could be driven by a desire maintain a lower perception of leverage and thus preserve existing market value of the security.

The Struggling Class of '85: Strategies for the Future

New Directions for Copley Properties, Inc.

The symptoms clearly indicate Copley has been hit by the poor real estate market-- reduced cash flows, reduced dividend payments and a share price that trades much lower than the appraised value of real estate per share. During the development and lease-up phases of projects, the company received a significant portion of its cash from guaranteed returns. As the agreements expired the company had to rely on actual rental revenues generated by the properties. Rent concessions and higher than expected vacancy rates significantly reduced the rental income from earlier proforma projections. Management's 1989 report to shareholders attributes the decline in reported cash from operations to this transition.

In response management has taken several steps to reposition the company. First, in an effort to shore up cash flow, the company has imposed an operating expense cap of $650,000. Expenses above and beyond the cap will be offset with a reduction in the advisor's management fee. One expense to be eliminated is the annual appraisal of the properties; few equity REITs provide this information on a regular annual basis. Second, Copley Properties is actively repurchasing its own shares, up to 500,000 shares or 12.5% of its stock. The stated reason for the repurchase is that, because the market price is so far below the appraised value, management believes this to be an effective use of resources that will benefit the shareholders. Third, Copley plans to make strategic sales of portfolio holdings, particularly any land holdings which have a long developmental time frame.

Aside from the operational changes, Copley has indicated that the REIT will move away from the original development strategy. In the short run, gains from property sales will be used to purchase assets that will generate more current income, i.e. completed and leased buildings. As in the past, the investment strategy of the REIT mirrors the investment strategy that the advisor employs with its institutional accounts. In the years to come, Copley intends to avoid pure multi-phased development projects of the past and concentrate instead on property investments which are partially complete or require relatively short-term renovation, rehabilitation or development. Whether this change is a commentary on the original strategy or just a response to current market forces, it would appear that by focusing on renovation opportunities Copley is moving closer toward the methods employed by the Acquisition & Redevelopment group of REITs.

MSA Realty Liquidation

MSA, like most other public companies, markets itself to shareholders with glossy, well-designed, full-color annual reports. At the risk of judging a book by its cover, the 1989 annual report signaled that MSA was suffering cash flow problems-- before opening to the first page. In an effort to reduce printing costs, the latest report is simply a copy of the 10-K and a cover letter, bound simply in a white paper cover. The text inside confirms that cash flow is indeed a problem and that MSA's solution to the tough market is to liquidate. The company has retained Morgan Stanley Realty Incorporated to seek out potential purchasers. Liquidation of securitized assets can be difficult, particularly if the assets are under development or not fully leased. The REIT format also poses problems for selling out. Liquidation of a REIT is a viable strategy on an all-or-nothing basis only. If a company sells assets slowly, on a property-by-property basis, then it is at risk of losing REIT status due to excessive income from gains on sales. MSA, for example, sold its interests in four joint ventures to a wholly-owned subsidiary of the advisor, Melvin Simon & Associates. If, however, MSA cannot sell substantially all the rest of its assets by year end, then it has retained the right to buy the four joint ventures right back again.

The Expansion of ICM Property Investors

As we saw earlier, cash flow from operations is also a problem for ICM. One of the apparent disadvantages shared by all of the Joint Venture REITs is the lack of an existing portfolio. ICM Property Investors' solution is to go out and get one. In a unique transaction, still under negotiation at the time of this writing, ICM is seeking to raise cash flow levels through the purchase of several existing industrial properties from California developer Peter B. Bedford. Instead of a cash price, Bedford will receive 1,000,000 newly issued shares of ICM stock, plus notes secured by purchase-money mortgages on the properties acquired. Bedford has offered ICM its choice of a portfolio of thirty industrial properties throughout the United States. ICM expects to acquire about 15 properties from the list of 30, with "an aggregate value that could reach $30 million or more." ICM is currently inspecting Bedford's properties to select which ones will be included in the transaction. Bedford is presently assessing values of the properties to establish "asking prices." In a separate transaction Bedford has also purchased all outstanding stock of Investors Central Management Corporation, ICM's privately owned investment manager.

Given the low stock price, ICM was unable to raise capital economically through conventional means. ICM management describes the Bedford transaction as a private means of financing portfolio expansion. Strategically, the purchase also represents a shift away from the from the original development investment plan. The stated goals of the transaction are to diversify the investment portfolio, increase total assets and cash flow, and to narrow the present gap between cash flow from operations and distributions.[20]

This transaction, and its final impact to the other shareholders, raises some interesting questions. While it is true that the added leased properties in the portfolio will increase cash flows from rents, the issuance of one million new shares requires that the new income be distributed over that many more shares. Also, purchase money mortgages, which are effectively seller-financing, will require debt service payments that will also reduce net cash flow. Only the final outcome of the deal will will determine the impact on dividends and share value. The transaction itself, however, underscores the versatility of the REIT vehicle. If ICM management accomplishes what they have described to shareholders, they will have found a way to finance a $30-million purchase through a REIT that has only declined in value out over its five-year life.

CHAPTER FOUR

CONCLUSIONS

A real estate investment trust is a simply a creature of the Internal Revenue Code and securities law. "REIT" alone does not describe a business. Any particular REIT must be evaluated first, as a real estate company based on its own individual strategies and practices. Second, one must consider how well that particular company can achieve its goals within the confines of the REIT legislative and regulatory structure. Finally, as a publicly traded security, a REITs' operational and financial strategy can be hindered, or helped, by the external condition of the stock market.

The Acquisition & Redevelopment REITs have successfully used development and renovation to add value to their portfolios. They were able to this, in moderation, primarily because their broad portfolios of existing properties generated income that enabled them to cover the front-end negative cash flows of the development effort and to continue paying out dividends, and even increase them, without interruption. Renovation and development have been employed successfully as one component of management's overall strategy. The REIT vehicle has afforded these A & R REITs a means to raise capital in a variety of ways and thereby continually increase their asset base. Each of them have increased the volume and diversity of their individual capital structures over the past five years. The primary objective of these companies has been to amass portfolios of attractive income properties and manage them effectively to maximize profits. Recent expansive interpretation of the tax code has permitted freedom to pursue these goals more independently and aggressively. Given the current real estate market environment, strategies that focus on finding undervalued assets, redevelopment and diligent property management seem to make more sense than development from the ground up.

Poor securities performance is one indicator that the Joint Venture REITs face problems today stemming from low cash flow from their real estate investments. These companies' investments were not diversified between new development and existing income properties. After lengthy development and construction periods, their first completed projects entered the lease-up phase during an unforeseen tough real estate markets marked by oversupply and free-rent concessions. Without other leased properties to offset the losses, these REITs were left no choice but to throw additional capital at the anemic joint ventures and to reduce distributions to equity shareholders. For this group, the REIT vehicle has served as a means to raise equity capital one time only-- at the initial public offering. Debt capital has been added through permanent mortgage refinancing of completed properties and short-term lines of credit. These REITs are not likely to grow substantially without new equity to balance out the debt. Memories of 1974 and the downside risks of highly leveraged

REITs still haunt industry followers and investors. And as a result, the Class of '85 is not likely to raise additional public equity without improving the performance of their securities.

Since public perception of the real estate market influences the demand for REIT stock ownership, the Joint Venture companies have been especially hard hit on two fronts by the soft market. Joe O'Connor, chairman of Copley Realty Advisors, recently claimed that, "The real estate market is just getting bad enough to where I feel good about it again." His point is that, if the current market conditions are cyclical, then down times can bring bargain investment opportunities. To a real estate professional this concept makes perfect sense. But generally, stock market investors look to previous performance records to foreshadow future trends. It takes positive past performance to fill the bandwagon with new investors. REIT stocks are not gaining popularity as an investment. For the twelve months preceding May 1990, the NAREIT share price index, for Equity and Hybrid REITs, fell 10% and 35% respectively. Over the same time period aggregate twelve month total returns were -2.36% for Equity REITs and -21.69% for Hybrids.[21] REIT managers who identify attractive investment opportunities now, at what might be the valley of a real estate market cycle, will have a difficult task raising public interest for investment. Furthermore, current yields will be prohibitive for raising capital.

To summarize, any development business, including a

REIT, is susceptible to real estate market risks. Publicly traded REITs depend on cash flow to prosper. Interruption in cash flow due to risk exposure in real estate markets can have detrimental effects on the security's stability and thus the REIT. The plight of the class of '85 Joint Venture REITs illustrates this, but alternate external conditions could conceivably shake up the Acquisition & Redevelopment REITs as well. If, for example, oversupply or some other factor caused a drastic change in the demand for retail space in community shopping centers then the REITs concentrated in that area would face similar problems. IRT Property Company, for example, attributes lower cash flows in 1989 to an externality; the bankruptcy of one of their anchor tenant chains, Revco Drugs. But the Acquisition & Redevelopment REITs have a distinct advantage that comes with age. Start-up for the Joint Venture development REITs further compounded their exposure to market risks since all of the initial portfolios consisted of unproven properties.

The REIT vehicle can facilitate development, that much is clear. But real estate development, alone, will not facilitate the income requirements of public ownership. For REITs to be effective development machines, they need steady reliable cash flow sources in the portfolio. Otherwise, they cannot survive in the highly cyclical real estate markets.

Current Trends and New Applications of the REIT

In their relatively short history, the definitive chapter on REITs as developers is still being written. All of the discussion and analysis thus far have centered on publicly traded REITs. Many of the problems already covered are due to complexities and costs associated with the unforgiving public securities market. There is, however, another way that a REIT vehicle can facilitate real estate development and circumvent the problems of entry barriers, share volatility, high public offering costs and high operating costs-- through the use of a private REIT. The use of private REITs, as a start-up technique, may allow for a new REIT to weather some initial cash flow shortages without forever tarnishing its track record in the public market.

Private REITs

It is important to note that the private REIT vehicle is chosen primarily to enable its investors to circumvent an onerous tax statute, not to access public capital. The key investors in most private REITs are already flush with capital. Typically such investors are large nonprofit institutions like pension plans, endowments, and foundations; not small individual shareholders.

The Internal Revenue Code restricts the use of borrowed money by tax-exempt institutions. Although detailed and complex restrictions vary by the type of institution, in short, some tax-exempts are prohibited from investing in "debt financed property" as defined by the Code. Virtually all real estate investments, especially development projects, are debt financed. Judicious use of leverage is, by and large, a desirable way to enhance real estate returns, even for risk-averse institutions. The REIT structure serves as a conduit through which tax-exempt institutions can benefit from the use of leverage without technically investing in debt-financed property.

In simple terms the deals are set up in the following way: The private REIT and a developer establish a joint venture partnership, a separate business entity with just two partners. The REIT provides the equity capital and the developer provides the skill and expertise. This partnership, not the REIT, is the entity that incurs debt and develops the real estate projects. The investors in the REIT, tax-exempt nonprofits, are thus insulated from the debt financed property, which is held by the joint venture. Such private trusts are set up as corporations that qualify for REIT status under the Internal Revenue Code, but kept intentionally small enough, less than 500 shareholders, to avoid costly filing procedures with the Securities and Exchange Commission.

Property Capital Advisors, Inc. (PCA) of Boston is the advisory firm that handles Property Capital Trust, a public equity REIT that trades on the American Stock Exchange. While Property Capital Trust has participated for years in development projects as a joint venture partner and permanent lender, its advisor (PCA) also operates two separate private REITs, PCA/Sammis and PCA/Tishman Speyer. Each of the two REITs are reportedly capitalized with approximately $120 million in equity. (These are private companies and specific financial information is not available.) The PCA/Sammis REIT holds around twenty five properties while the PCA/Tishman-Speyer REIT holds only three. The two PCA private REITs each have about twenty institutional investors who provide the necessary working capital, although the required minimum number of shareholders to form a REIT is one hundred. In some cases minimal shareholdings must be sold to individuals in order to meet the minimum requirement. Pension plans count as one single individual shareholder whereas nonprofit corporations can count each of their shareholders as individual shareholders in the REIT. Large pension plan participants can create complications since private REITs must also meet the test that no more than 50% of the shares can be owned by five or fewer individuals.

According to Robert Melzer, President of PCA, even private REITs face some of the familiar complications of adhering to the cumbersome REIT regulations. Excess cash, which can be substantial at times, is a problem because it must be put into real estate related investments. The four-year minimum holding period inhibits the timely sale of certain property. Because REITs are forbidden from profiting from certain operational income, like tenant improvement services, the REIT must forfeit some of the income to the developer or negotiate additional compensation through some other acceptible activity.

The private approach holds interesting prospects for new development REITs, which are perceived as particularly high-risk investments and substantially discounted on the common market. As previously mentioned, entrepreneurs and developers often identify investment opportunities at the "bottom" of a market cycle, when the mainstream securities-buying public is least likely to invest. It is conceivable that the private vehicles could be used as "incubators," designed specifically not to trade in a major public market until after they have an opportunity to develop a track record. Access to capital during the incubation period would be augmented through joint venture partnerships and private placements with institutional money sources. After demonstrating success with institutional funds the REIT could reasonably "go public" to tap additional sources of capital.[22]

REIT/REMIC Strategies

Another suggested development framework that may be a viable of choice in the 1990s is a combination REIT/REMIC vehicle. The real estate mortgage investment conduit (REMIC) was created under the Tax Reform Act of 1986 to become the standard form of trading real estate mortgage-backed securities. Combining a REIT with a REMIC is a complex arrangement, but it fully exploits the current legislation to overcome some of the start-up problems faced by development REITs. It also provides the REIT a means to additional capital through access to the secondary mortgage market. To illustrate, Weirick's hypothetical example[23] outlined below weaves together several parameters that might characterize publicly funded development projects of the 1990s; a renovation of an old warehouse building near downtown, a build-to-suit finish out requirement for a long-term tenant, and a public/private partnership arrangement with the city to encourage further redevelopment of the warehouse area.

Assume that the owner of the property has identified a potential tenant interested in occupying the warehouse, provided it could be redeveloped to a high quality standard. The first step is the property owner, together with several other private investors, forms an S corporation to supply the initial investment capital. This set-up lets the investors capture losses and any rehabilitation tax credits. The S corporation, the tenant, and the city enter into a development agreement. The tenant signs a lease, partially guaranteed by the city (if required), so that additional financing can be obtained from local institutions. Development proceeds. Meanwhile, the city and the S corporation work together with master planning architects to design a development scheme for the surrounding area.

Sometime after the first property is completed and demonstrates acceptable cash flow, the city initiates the formation of a REIT. The REIT sells shares to raise capital to buy the warehouse from the Subchapter S corporation and to engage in further development of the area. The city's REIT is set up so that it can also be a REMIC. A property owner can transfer property at fair market value to a REMIC in return for a stream of future payments without being subject to capital gains upon the swap. Thus, the S corporation can swap its warehouse for an interest in the REMIC to realize an income flow rather than a lump sum. The income to the owner would be principal and interest payments based on fair market value of the property and it would be classified as portfolio income for tax purposes. A REMIC can issue multiple classes of investor interests (securities) backed by a pool of mortgages. Sale of REMIC shares based on the mortgage allows financing to be customized with offerings in the mortgage securities secondary market. Mortgaging of the property will free up the investor capital to pursue additional projects.

Now that the REIT has been established, the city can use it to undertake infrastructure improvements in the area. New renovation projects can also be developed, in a variety of ways. One way is for the city's REIT to identify a seller, obtain a long-term tenant commitment and purchase the next old warehouse. The lease could be structured so that the tenant could serve as independent contractor to be the legal developer of its own new facility. Lease payments could be adjusted (lower) during the development period to allow for constructions expenditure. Through REMIC status, the REIT can convert its assets into mortgage-backed securities, providing even more efficient access to the capital markets.

This suggested public use of the REIT is an untested strategy that would require thorough research and legal review before it could actually be implemented. It is included, however, to demonstrate that creative thinking may lead to new and innovative uses of the REIT vehicle.

Final Note-

Further development of this country is likely to taper in the years to come. More emphasis will be placed on attentive asset management and renovation of underutilized existing structures. The representative Acquisition & Development REITs have demonstrated that these activities can be capably handled through the REIT vehicle. Favorable legislation in recent years has strengthened the REIT, and new frontiers in exploiting the rules are still being explored. Securitization, which has provided investors with a comfortably more efficient real estate market, will continue to play a major role in many real estate transactions. Although it represents a very small facet of the overall real estate industry, development through the REIT vehicle seems to be a logical choice in the current market. The use of REITs for development is likely to continue through the 1990s and the evolution of new techniques will surely improve the process over time.

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